

REPORT OF EXAMINATION
SAFECO INSURANCE COMPANY OF AMERICA

Seattle, Washington

December 31, 2000

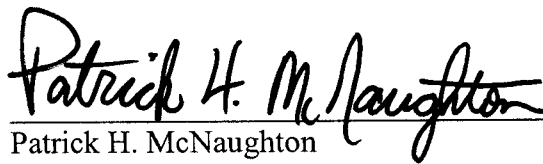


States Participating:

Washington
Delaware
Nevada

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify that I have reviewed the attached Report of Examination of the financial condition and affairs of SAFECO INSURANCE COMPANY OF AMERICA of Seattle, Washington, as of December 31, 2000.



Patrick H. McNaughton
Chief Examiner

9-11-03

Date

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SALUTATION

Seattle, Washington
August 27, 2003

The Honorable Alfred W. Gross
Commissioner, Commonwealth of Virginia
Chair, NAIC Financial Condition (EX)
Committee
State Corporation Commission
Bureau of Insurance
PO Box 1157
Richmond, VA 23218

The Honorable John Morrison
Commissioner, Montana Department of
Insurance
NAIC Secretary, Western Zone
840 Helena Avenue
Helena, MT 59601

The Honorable Susan F. Cogswell
Commissioner, Connecticut Dept. of
Insurance
NAIC Secretary, Northeastern Zone
PO Box 816
Hartford, CT 06142-0816

Honorable Mike Kreidler
Commissioner, Washington State
Office of Insurance Commissioner
5000 Capitol Boulevard
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutory requirements of Chapter 48.03 of the Revised Code of Washington (RCW), an Association Examination was made of the corporate affairs and financial records of the

SAFECO INSURANCE COMPANY OF AMERICA

of
Seattle, Washington

hereinafter referred to as the Company, at its home office located at SAFECO Plaza, 4333 Brooklyn Avenue Northeast, Seattle, Washington 98185.

The Company wrote personal, commercial and surety lines of insurance through independent agents. Included in the lines of insurance written are automobile, homeowners, fire, commercial multiple peril, workers' compensation, miscellaneous casualty, surety and fidelity. The Company was licensed in all states, the District of Columbia, Guam and the Dominion of Canada. A

listing of the Company's affiliates and the Company's relationship as a member of an insurance holding company system is included in this Report of Examination under the caption "AFFILIATED COMPANIES". The Company was under the control of and managed by a Board of Directors. Officers were appointed by the Board of Directors to operate the Company. The Company had extensive reinsurance transactions with its affiliates in that it assumed all of the business written by every property and casualty insurance company within the insurance holding company system and had ceded certain percentages to a select number of its insurance company affiliates.

The last examination was as of December 31, 1995. The following Report of Examination is respectfully submitted showing the condition of the Company as of December 31, 2000.

SCOPE OF EXAMINATION

Per RCW 48.03.010, the examination covered the five-year period from January 1, 1996 through December 31, 2000. The Company was last examined as of December 31, 1995 by examiners representing Washington, Delaware and Ohio (General Interrogatory No. 22 (d) of the Company's 2000 Annual Statement incorrectly reported that the last financial examination was made by the Washington, Louisiana, Vermont, Illinois and North Dakota Insurance Departments). On April 19, 2001, an Association Examination was called to begin on June 4, 2001. Insurance examiners from the states of Washington, Delaware and Nevada conducted the current examination concurrently with the Association Examination of five other companies domiciled in Washington - General Insurance Company of America, First National Insurance Company of America, SAFECO Surplus Lines Insurance Company, SAFECO Life Insurance Company and SAFECO National Life Insurance Company. The Southeastern and Midwestern Zones of the National Association of Insurance Commissioners (NAIC) were invited to participate in the examination but elected to decline.

A December 31, 2000 examination of SAFECO National Insurance Company was conducted concurrently by the Missouri Insurance Department. December 31, 2000 examinations of SAFECO Insurance Company of Illinois and its subsidiary, Insurance Company of Illinois, were also conducted concurrently by the Illinois Insurance Department.

The examination of the Company was conducted in accordance with the laws and regulations of the state of Washington contained in Title 48 RCW and Title 284 Washington Administrative Code (WAC) and the examination procedures prescribed by the NAIC Financial Condition Examiner's Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. Comments on any adverse findings that are applicable to the current examination are included in the "INSTRUCTIONS", "COMMENTS AND RECOMMENDATIONS" and in "ACCOUNTS AND RECORDS" sections of this report.

INSTRUCTIONS

The examination disclosed the following issues that require Company action:

1. Inadequate Accounts and Records

Our examination of the Company disclosed numerous areas in which the Company's accounts and records were found to be deficient, insufficient, or inaccurate to provide for and ensure full and adequate disclosure. The Company is instructed to comply with RCW 48.05.280 which requires the Company to keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The results of the examination disclosed the following insufficiencies, errors, and inadequacies:

- a) The Bank of New York, custodial bank, reported 14,000 shares of Financial Corporation of America preferred stock as of December 31, 2000. These shares were not reported in Schedule D, Part 2, Section 1 of the Company's 2000 Annual Statement. The Company responded that the shares were held in Portfolio 995 as being worthless stock and that assets held in Portfolio 995 do not print in Schedule D. On February 26, 2002, the Company transferred the shares back to the active account and indicated that these shares would be reported in future annual statements. The Company's failure to list the shares in its 2000 Annual Statement was not in compliance with RCW 48.05.280 which requires that the Company keep full and adequate records of its assets, obligations, transactions and affairs.
- b) Schedule D, Part 4 of the Company's 2000 Annual Statement reported the loss of \$2,449,755 on BankAmerica Manufactured Housing (CUSIP 06606F-AM-3). No consideration was reported in column 5 of Schedule D, Part 4 even though the name of the purchaser was listed as "Paydown." The security was reported in Schedule D, Part 1 of the Company's 2000 Annual Statement as having a book value of \$2,548,656, a par value of \$5,000,000, a market value of \$4,327,000 and an admitted value of \$1,877,245. Subsequent to December 31, 2000, the Company wrote up the book value of the security by \$622,755. The Company's response was that the security was determined to be impaired in 2000 and the system was closed so the Company manually wrote the asset down to a book value of \$2,500,000 (that is the Company did not write the value down within the Portfolio Accounting Management System (PAM) as the entry was made outside the system).

The Company indicated that the individual preparing the Annual Statement inadvertently wrote down both the book value and the statement value by the amount of the impairment and this prevented the system from placing the lower of cost or market into the statement value section of the 2000 Annual Statement. In addition, the Company indicated that the correct admitted value should have been \$2,500,000 rather than the \$1,877,245 and indicated that after year-end 2000 when the adjustment was keyed into the PAM system, the PAM system took an additional \$48,749 in realized loss to bring it down to the impaired

value of \$1,828,496. Since the 2000 Annual Statement value was too low, the system automatically adjusted the value up to the correct book/statement value in 2001 by \$671,504 (\$622,755 plus \$48,749). The Company's failure to list the correct amounts for this security in its 2000 Annual Statement was not in compliance with RCW 48.05.280 which requires that the Company keep full and adequate records of its assets, obligations, transactions and affairs.

- c) Schedule D, Part 4 of the Company's 1999 Annual Statement reported the disposal of 273,582 units (shares) of First Place Tower, Inc., with the name of purchaser listed as "None". The Company responded that the disposal was a tender offer. RCW 48.05.250(1) requires the Company to file a true statement of its financial condition, transactions and affairs.
- d) The results of the examination disclosed numerous internal control deficiencies, some of which are detailed in the "ACCOUNTS AND RECORDS" section of this report. Pursuant to RCW 48.05.280, the Company is required to ensure that all accounting controls be reviewed, and deficiencies identified and corrected.

2. Loss and Loss Adjustment Expense Reserves

The reserves carried by the combined property and casualty companies of the SAFECO Group for these liabilities were \$3,482,472,780 and \$786,665,886, respectively, as of December 31, 2000.

The reserves for the combined companies were reviewed by the casualty actuarial staff employed by the Washington Office of Insurance Commissioner (OIC). The actuarial staff selected several lines of business, comprising approximately 59% of the companies' gross loss and loss adjustment expense reserves, for detailed review. Company personnel provided loss and loss adjustment expense development data for these lines of business as of June 30, 2002 (in other words, the data included eighteen months of development subsequent to the examination period). Company personnel also provided additional information by electronic mail and in several face-to-face meetings. The actuarial staff also reviewed actuarial reports and Statement of Actuarial Opinion prepared by the companies' Board of Directors appointed consulting actuarial firm, Ernst & Young LLP.

Based on their analysis of data through June 30, 2002, the OIC's actuarial staff concluded that the companies' booked reserves, particularly for the workers' compensation and general liability lines of business, were deficient as of December 31, 2000. Since December 31, 2000, the companies have taken significant steps to strengthen their loss and loss adjustment expense reserves for 2000 and prior years. These steps were reflected, in part, in the one year loss development of \$339,274,000 for all lines of business shown on Page 23 of the combined companies' 2001 Annual Statement.

The OIC's actuarial staff made the following examination adjustments to the reserves as of December 31, 2000, on a combined-companies basis:

	<u>Booked Reserve</u>	<u>Examination Adjustment</u>	<u>Restated Reserve</u>
Losses	\$3,482,472,780	\$357,829,000	\$3,840,301,780
Loss adjustment expenses	786,665,886	93,742,000	880,407,886

Under the SAFECO intercompany pooling agreement, the Company's liability was 33% of the total. Therefore, the examination adjustments to the Company's reserves as of December 31, 2000 were:

	<u>Booked Reserve</u>	<u>Examination Adjustment</u>	<u>Restated Reserve</u>
Losses	\$1,149,216,017	\$118,083,570	\$1,267,299,587
Loss adjustment expenses	259,599,741	30,934,860	290,534,601

The Company is instructed to make provision for the examination adjustments to its loss and loss adjustment expense reserves which will place the Company in compliance with RCW 48.12.030(2), which provides that the Company estimate its provision to pay its unpaid losses and claims incurred on or prior to the date of the annual statement together with the expense of adjustment or settlement thereof.

3. Prohibited Investments in Foreign Securities

The Company had invested in foreign bonds (excluding Canadian bonds) having an admitted value of \$20,884,353 and admitted accrued interest on those bonds of \$203,963 as of December 31, 2000. As of December 31, 2000, the Company transacted business only in the United States and Canada. The Company reported \$9,772,353 in foreign securities in "Schedule D – Summary by Other Countries" in its 2000 Annual Statement; however, the Company failed to include \$11,112,000 of the securities of Global Crossing Holding Limited, Commonwealth Bank of Australia, and Flextronics International Limited as foreign bonds, other than Canadian securities, owned as of December 31, 2000. The Company's failure to list the three securities as foreign investments was not in compliance with RCW 48.05.250(1).

Additionally, the Company had invested in one foreign preferred stock having an admitted value of \$9,825,200 and \$203,640 in dividends declared and unpaid, and one foreign common stock with a market value of \$938,154, as of December 31, 2000. It was determined that the \$938,154 admitted value for the foreign common stock as reported by the Company in its 2000 Annual Statement was incorrect. The foreign common stock had a December 31, 2000 market value of \$111,160 resulting in an \$826,994 examination adjustment to this report.

The Company made the investment transactions in foreign securities under the belief that the foreign securities were permitted and allowed as miscellaneous assets under RCW 48.13.240. The OIC indicated that investments in foreign securities were limited to those categories described in RCW 48.13.180, which allows for investments in foreign securities in an aggregate amount not exceeding its deposit and reserve requirements for that country.

The Company is instructed to comply with RCW 48.13.290(1) which states, “Any ineligible personal property or securities acquired by an insurer may be required to be disposed of within the time not less than six months specified by order of the commissioner, unless before that time it attains the standard of eligibility. . . ” Under this Examination Order, the Company will be required to dispose of ineligible foreign securities in a time frame as specified under Special Consent Order No. 96. See item No. 1 under “SUBSEQUENT EVENTS” for special consent order No. 96 issued by the OIC on December 20, 2002.

4. Insurer Holding Company Act Violation

SAFECO Asset Management Company (SAM), an affiliate acquired by SAFECO Corporation in 1973, serves as the investment advisor for the Company and its affiliates. Numerous investment transactions were conducted between the Company and SAM during the five year period under review for which no intercompany agreement was in force to define the rights and responsibilities and cost reimbursement methodologies.

These affiliate services performed by SAM are required to be “fair and reasonable” as to terms and charges pursuant to RCW 48.31B.030(1)(a)(i) and (ii). In addition, RCW 48.31B.030(1)(a) requires: “(iii) Expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices consistently applied; (iv) The books, accounts, and records of each party to such transactions must be so maintained as to clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties.”

The Company is instructed pursuant to RCW 48.31B.030(1)(b)(iv) to submit for approval to the OIC an intercompany agreement with SAM and all pertinent affiliates which complies with RCW 48.31B.030(1)(a).

5. Holding Company Securities Transactions Reporting

Our examination disclosed the Company had the following violations of the Chapter 48.31B RCW of the Insurer Holding Company Act:

- a) Schedule D, Part 2 of the Company’s December 31, 1995 Annual Statement reported that the Company owned 502,372 shares of SAFECO Washington State Municipal Bond Fund; 605,644 shares of SAFECO Insured Municipal Bond Fund; 500,000 shares of SAFECO Intermediate-Term US Treasury Fund; 397,434 shares of SAFECO Intermediate-Term Municipal Bond Fund; and 500,000 shares of SAFECO Northwest Fund. Schedule D, Part 4 of the Company’s 1994 Annual Statement reported \$7,033 in consideration received from

SAFECO Washington State Municipal Bond Fund and \$803,000 in consideration received from SAFECO Northwest Fund; however, the Schedule did not reflect any shares of stock as being redeemed. Schedule D, Part 4 of the Company's 1997 Annual Statement reported \$569,500 in consideration received from SAFECO Northwest Fund; however, the Schedule did not reflect any shares of stock as being redeemed. Schedule D, Part 4 of the Company's 1998 Annual Statement reported the sale of 50,000 shares of SAFECO Northwest Fund for a consideration of \$1,028,750 (the Company realized a gain of \$528,750 on the sale). Schedule D, Part 4 of the Company's 1999 Annual Statement reported \$907,300 in consideration from SAFECO Northwest Fund; however, the Schedule did not reflect any shares of stock as being redeemed. Schedule D, Part 4 of the Company's 2000 Annual Statement reported the sale of the 502,372 shares of SAFECO Washington State Municipal Bond Fund for a consideration of \$4,918,227 (the Company realized a loss of \$81,773 on the sale).

The SAFECO mutual fund redemptions made during the period under review were neither reported in Schedule Y, Part 2 of the Company's Annual Statements, nor were they reported pursuant to the Washington Insurer Holding Company Act. The various SAFECO mutual funds were not listed on the Organization Chart in Schedule Y, Part 1 of the Company's 1996, 1997, 1998, 1999 or 2000 Annual Statements as required by the NAIC Annual Statement Instructions. As of December 31, 2000, the Company owned 605,644 shares of SAFECO Insured Municipal Bond; 500,000 shares of SAFECO Intermediate-Term US Treasury Fund; 397,434 shares of SAFECO Intermediate-Term Municipal Bond Fund; and 450,000 shares SAFECO Northwest Fund. The Company's failure to include the transactions in Schedule Y were violations RCW 48.31B.030(1)(b)(i) and 48.05.250(1).

- b) During 1999, the Company transferred one security to a subsidiary, SAFECO Surplus Lines Insurance Company, and during 1998, the Company transferred two securities each to affiliates SAFECO National Insurance Company; SAFECO Insurance Company of Illinois; and General Insurance Company of America. During 1998, General Insurance Company of America and another affiliate, American States Insurance Company, transferred two securities each to the Company. Additionally, another affiliate, American Economy Insurance Company, transferred one security to the Company. None of the intercompany transfers were included in the Holding Company Reports filed with the OIC. The Company's answer to the missed filings was that the transfers were not included in the Holding Company Reports as such reports are not system generated, but were completed manually. The Company's response to the examination team indicated that due to the large volume of transfers during 1998 to settle the new intercompany pooling agreement, some transfers may have been inadvertently left out of the filings, however, since Schedule D is system generated, the transfers were included in Schedule D each year. The failure to report the transactions in the holding company filings was a violation of RCW 48.31B.030(1)(b)(i) and 48.31B.025. The Company was not in compliance with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition.

The Company is instructed to comply with RCW 48.31B.030(1)(b)(i) and 48.31B.025 which requires the filing of insurance holding company reports detailing transactions with parent companies, subsidiaries and affiliates. The Company is instructed to comply with RCW 48.05.280 which provides that every insurer shall keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition.

6. Errors in Annual Statements

Review of the Company's Annual Statements for the period under examination disclosed several errors and/or omissions. RCW 48.05.250(1) states, "Each authorized insurer shall annually, before the first day of March, file with the commissioner a true statement of its financial condition, transactions and affairs as of the thirty-first day of December preceding. The statement forms shall be in general form and context as approved by the National Association of Insurance Commissioners for the kinds of insurance to be reported upon, and as supplemented for additional information required by this code and by the commissioner."

The Company is instructed to review and continue its efforts to substantially strengthen controls to comply with RCW 48.05.250(1) which requires the Company to file a true statement of its financial condition, transactions and affairs. The results of the examination disclosed the following errors in the Company's Annual Statements:

a) Emerald City Insurance Agency, Inc.

Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement reported the ownership of stock in Emerald City Insurance Company, a subsidiary, for which the Company reported no admitted value. The correct name of this entity was Emerald City Insurance Agency, Inc. The Company indicated that it had no December 31, 2000 financial statements for this subsidiary. The Company was not in compliance with RCW 48.05.280 which requires the Company to keep full and adequate records of its assets. The NAIC Annual Statement Instructions indicated for Schedule Y, Part 1, that a chart or listing presenting the identities of and interrelationships between the parent, all affiliated insurers and other affiliates should be attached to the Annual Statement. RCW 48.05.250 defined an insurer as every person engaged in the business of making contracts of insurance. The Company did not list Emerald City Insurance Agency, Inc. in Schedule Y, Part 1 which the Company owned and conducted the business of making contracts of insurance which is not in compliance with RCW 48.05.250.

b) SAFECO UK Limited

SAFECO UK Limited was listed as being 100% owned by SAFECO Corporation in the March 1, 2001 SAFECO Corporation Organizational and Entity Chart. However, SAFECO UK Limited was not listed in Schedule Y, Part 1 of the Company's 1998, 1999 or 2000 Annual Statements. The Company's failure to report SAFECO UK Limited in Schedule Y, Part 1 was not in compliance with RCW 48.05.250(1).

c) Market Square Holding, Inc.

The Company reported on Schedule D, Part 2, Section 2 of its 2000 Annual Statement the ownership of 950 shares of Market Square Holding, Inc., at no admitted value. Schedule Y, Part 1 of the Company's 1996 Annual Statement reported that Market Square Holding, Inc., was 95% owned by the Company and that Market Square Holding, Inc., owned 100% of Market Square Real Estate. In 1997, Market Square Real Estate was sold by Market Square Holding, Inc., to a non-affiliated entity. Market Square Holding, Inc., had no assets and did not issue any financial statements as of December 31, 2000. While the shares had no value as of December 31, 2000, Market Square Holding, Inc., should have been reported as a subsidiary by the Company in Schedule D, Part 2, Section 2 and the correct number of shares should have been reported as 1,000 rather than the 950 as indicated (the Company received 50 shares, the remaining 5%, held by the property manager when the real estate was foreclosed in the early 1990's). The Company had a contingent liability of \$10,136,987 in connection with a letter of credit and a guaranty of bonds issued by the City of Minneapolis, Minnesota, that was reported in the Notes to the Financial Statements of the 2000 Annual Statement. The City of Minneapolis had issued the bonds in 1993 as part of the refinancing of the Market Square property held by Market Square Holding, Inc.

d) SAFECO Affiliate Reporting

Schedule DA, Part 1 of the Company's 2000 Annual Statement incorrectly reported a \$75,510,000 short-term investment in SAFECO Affiliates. The \$75,510,000 investment was made in non-affiliated entities and consisted of overnight investments of \$34,865,000 in AIM International Services, \$10,235,000 in the Bank of Montreal and \$30,410,000 in Federated Investors.

e) Interest Due and Accrued – Various

Schedule D, Part 1, Column 12 of the Company's 2000 Annual Statement reported \$81,550 in interest due and accrued on Rural Metro Corporation bonds and \$285,746 in interest due and accrued on BankAmerica Manufactured Housing bonds as being on bonds in default as to principal and interest. The Company received the stated amount of interest on the two bonds during 2000. The two bonds were not in default as to principal or interest as of December 31, 2000 and the amounts should not have been reported in the 2000 Annual Statement. The Company reported no accrued interest on the two bonds in Schedule D, Part 1, Column 9.1 – Amount Due and Accrued December 31 of Current Year on Bonds Not in Default. No proposed adjustments were needed as the Company did not admit any accrued interest on either security as of December 31, 2000.

7. Promissory Note from Affiliate

During December 1998, the Company loaned \$38,100,000 to an affiliate, General America Corporation, for the purpose of purchasing the real estate known as Lot 1 of the SAFECO Redmond Campus located in Redmond, Washington, consisting of two buildings and excess land. General America Corporation gave a Promissory Note to the Company; however, this note

was not in the name of the Company but issued to SAFECO Insurance Corporation, an unknown entity. Furthermore, the Company had listed this Promissory Note on each of its Annual Statements for 1998 through and including 2000 as an account receivable. As of December 31, 2000, the Company indicated that it had an account receivable of \$42,786,965 (the \$38,100,000 plus \$4,686,965 of interest through December 19, 2000) for this Promissory Note. General America Corporation had not paid any interest or principal on this Promissory Note as of December 31, 2000.

General America Corporation gave a deed of trust for the benefit of the Company on the same date that it issued the Promissory Note. The deed of trust was recorded in King County, Washington, on December 31, 1998 and a title policy was issued to the Company on the same date. The issuance of an evidence of debt, the Promissory Note, secured by a recorded deed of trust, placed this asset under the provisions of RCW 48.13.110(1)(a), which allows the Company to invest in such evidences of debt along with other mortgages, mortgage bonds, notes and contracts.

The reporting for this Promissory Note as an account receivable was an improper and inaccurate reporting of this asset on the Company's 1998, 1999 and 2000 Annual Statements. This was not in compliance with RCW 48.05.250(1) which requires a true statement of an insurer's financial condition, transactions, and affairs. The correct indication of this asset on the Company's Annual Statements for each year after receiving the Promissory Note was as an evidence of debt secured by a deed of trust, or in the general category as a mortgage loan on Schedule B of the Annual Statement blank.

At the time of the making of the Promissory Note, the Company obtained an appraisal by a Washington State certified appraiser. The appraiser presented a \$38,100,000 appraised value for the properties that secured the Company's loan. RCW 48.13.120(1) provides that an investment made pursuant to an evidence of debt, such as the Promissory Note that was secured by a deed of trust on improved commercial real property, shall not exceed seventy-five percent of the fair value of the particular property at the time of investment or \$28,575,000. The Company's loan of \$38,100,000 was a 100% loan at the time the loan was made. The \$9,525,000 in excess of the \$28,575,000 limit allowed plus the \$4,686,965 in accumulated interest in arrears past eighteen months totaled \$14,211,965 and this amount has been nonadmitted for the purpose of this examination. The Company should comply with RCW 48.13.110(1)(a) and 48.13.120(1) and list this Promissory Note as a mortgage loan or evidence of debt at an admitted value of \$28,575,000. The Promissory Note has been reclassified on the balance sheet of this Report of Examination from accounts receivable – other to mortgage loans on real estate.

RCW 48.31B.025(4) requires that affiliated transactions by the Company which involves more than one-half of 1% of prior year's admitted assets are required to be kept current and disclosed in its registration statement within fifteen days after the end of the month which the transaction transpires. At the time of the making of the Promissory Note, the admitted assets of the Company as of December 31, 1997, were \$2,731,360,752. One-half of 1% of these admitted

assets amounted to \$13,656,804, or an amount that was less than the \$38,100,000 original Promissory Note. A review of the holding company filings did not include a notification or filing of this material (as defined by RCW 48.31B.025(4)) transaction involving the Promissory Note from an affiliate.

A review of the minutes of the Board of Directors and the Finance Committee appointed by the Board of Directors did not indicate that the acquisition of the Promissory Note was authorized or approved as required by RCW 48.13.340. Furthermore, the Company's records for the Promissory Note did not contain the records required pursuant to RCW 48.05.280 and 48.13.350.

The Company is instructed to comply with RCW 48.13.110(1)(a) and 48.13.120(1) in listing and valuing its investment in the promissory note that is secured by a deed of trust. The Company is instructed to comply with RCW 48.31B.025 which requires the filing of insurance holding company reports detailing transactions with parent companies, subsidiaries and affiliates. The Company is instructed to comply with RCW 48.13.340 which requires the authorization or approval by the Company's Board of Directors. The Company is instructed to comply with RCW 48.05.280 which requires that the Company keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The Company is instructed to comply with RCW 48.13.350 which requires that the Company keep full and adequate accounts and records of its investments. The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

8. Bonds – Amortization

The Company was requested to provide bond amortization schedules for selected securities. The individual amortization schedules provided by the Company did not agree with the amortization reported in Schedule D of the Company's 2000 Annual Statement. The Company explained that it used a tool in PAM to prepare the schedules of bond amortization and that the amortization schedules provided were a very simplified way of determining amortization and were not expected to tie to Schedule D which uses more complicated models, algorithms, etc. The Company did not provide individual bond amortization schedules that would tie to the amortization reported in Schedule D.

The Company is instructed to correct and maintain amortization schedules on individual investments that will tie to the amortization reported in Schedule D of its annual statement and is instructed to comply with RCW 48.12.170(1)(b) which provides that bonds or evidences of debt having a fixed term and rate purchased above or below par shall be valued on the basis of the purchase price adjusted so as to bring the value to par at the earliest date callable at par or maturing at par or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner.

9. Bonds Pledged for Letter of Credit

A custodial affidavit for a bank confirmation received directly from the custodian indicated that the United States Government bonds held in a specific account were held by the custodian in the name of "SAFECO Ins. Co. of America – Citibank LC" and that these bonds were pledged to Citibank. The Company entered into a pledge and assignment agreement with Citibank effective November 25, 1998 whereby the Company pledged certain bonds to Citibank to be used as collateral for a letter of credit in connection with SAFECO UK Limited (beneficiary for the letter of credit was Lloyd's of London Corporate). SAFECO UK Limited is an affiliate of the Company. The bonds pledged under the agreement had a December 31, 2000 admitted value of \$46,241,942 and had \$738,672 in accrued interest as of December 31, 2000. RCW 48.12.010 provides in part, that an insurer is allowed only such assets as belong wholly and exclusively to the insurer. The Examiners have nonadmitted the entire \$46,241,942 in pledged bonds and the \$738,672 in accrued interest thereon.

The Company is instructed to comply with RCW 48.12.010 which provides that the Company is allowed only such assets as belong wholly and exclusively to the Company. The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

The assets that were pledged to Citibank were not reported by the Company in its 1999 and 2000 Annual Statements under General Interrogatory No. 20. The Company did not report the pledged assets in the 1998, 1999 and 2000 insurance holding company reports as filed with the OIC. The Company's failure to report the pledged assets in the General Interrogatories was not in compliance with RCW 48.05.250(1). The failure to include the assets pledged for SAFECO UK Limited in the insurance holding company reports was also not in compliance with RCW 48.31B.030(1)(b)(i) and 48.31B.025.

The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs. Additionally, the Company is instructed to comply with RCW 48.31B.030(1)(b)(i) and 48.31B.025 which requires the accurate filing of insurance holding company reports detailing transactions with parent companies, subsidiaries and affiliates.

10. Stock Valuations

The Company is instructed to review investments to maintain compliance with Chapter 48.13 RCW and nonadmit securities that do not meet the standards and requirements set forth therein. This will ensure compliance with RCW 48.12.180(1) which provides that the Company shall value its securities at market value and with RCW 48.13.050(1) which provides for investment in corporate obligations. The Company is instructed to comply with RCW 48.05.280 which requires that the Company keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

The following adjustments to the financial statements of this Report of Examination have been made as a result of this examination:

a) **Sherwood International PPC**

It was determined during the examination that the Company had one foreign common stock (Sherwood International PPC) having a stated value of \$938,154 that was overvalued by the Company and that had a true market value of \$111,160 as of December 31, 2000. The Company acknowledged that this security had dropped in value as of December 31, 2000 and the market value should have been reduced. **The Examiners have nonadmitted the \$826,994 overvaluation on the financial statements of this Report of Examination. The Company was not in compliance with RCW 48.12.180(1) which required that common stocks shall be valued at their market value.**

b) **AMS Services, Inc.**

During the examination, it was determined that the Company should have received only 23,451.5 of the 46,903 shares that the Company reported in Schedule D, Part 2, Section 2 of the 2000 Annual Statement for the Sherwood International PPC common stock received as a dividend from Sherwood International PPC's parent company, AMS Services, Inc. Because the Company and the Company's parent company, SAFECO Corporation, each individually owned 50% of AMS Services, Inc., at the time that AMS Services Inc., paid the Company and SAFECO Corporation the 46,903 shares, each should have recorded and valued only 23,451.5 shares. However, the Company recorded the entire 46,903 shares as its own.

Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement reported 36 shares of AMS Services, Inc., common stock having a cost and admitted value of \$252,647. This market value for the 36 shares was based upon a value assigned by the Company when the 179 shares of AMS Services, Inc., stock were acquired in 1999. After acquiring the 179 shares, the Company tendered 143 shares in 1999 leaving the 36 shares on the Company's books. As noted above, it was determined during the examination that the Company was entitled to only one-half of the 179 shares acquired in 1999 and should have been the owner of only 18 shares of the 36 shares of AMS Services, Inc., common stock remaining as of December 31, 2000. The Company was unable to secure a December 31, 2000 market rate or a financial statement for AMS Services, Inc., during the examination. **This stock was not valued by the NAIC Securities Valuation Office. The Company's \$252,647 admitted value for this common stock has been nonadmitted by the Examiners as the Company was unable to produce a market value for the stock.**

During 1999, the Company received \$3,328,983 in cash dividends on the 179 shares of AMS Services, Inc., common stock. On January 10, 2000, the Company received 60,180

shares of InsWeb common stock from AMS Services, Inc., as a dividend. The InsWeb shares were sold by the Company on January 24, 2000 for \$969,299. As noted previously, the Company is entitled to only one-half of the various dividends that it had received from these entities as the Company was entitled to only one-half of the 179 shares acquired in 1999 and was the actual owner of only 18 shares of the remaining 36 shares of AMS Services, Inc., common stock held as of December 31, 2000. During June 2000, the Company made a \$57,136 reimbursement for its share of expenses incurred in connection with the AMS Services, Inc., common shares tendered in 1999.

During the examination, the Company determined that SAFECO Corporation accounting records had six amounts totaling \$108,190 that were associated with the AMS Services, Inc., dividends. The \$2,120,574 amount derived from the books of the Company has been reduced to \$2,012,384 due to the \$108,190 SAFECO Corporation owed to the Company. During the examination, it was determined that SAFECO Corporation and the Company each owned one-half of the 179 shares of AMS Services, Inc., common stock and that both entities should have shared in one-half of the \$4,024,768 in net dividends and expense reimbursements. **The Examiners have established an adjustment of \$2,012,384 as a payable to SAFECO Corporation for SAFECO Corporation's 50% share of the income and expenses under the caption "Payable to Parent, Subsidiaries and Affiliates" in this Report of Examination.**

c) **Impact Community Capital LLC**

Schedule D, Part 2, Section 2 of the Company's 2000 Annual Statement reported one share of Impact Community Capital LLC Class B common stock having a cost and admitted value of \$51,387. The Company's admitted value of \$51,387 consisted of \$15,000 paid to Community Bank of the Bay in 1998 and a \$36,387 capital contribution received in 2000. The Company stated that there was no market price for this security and the Company carried the common stock at its book value as the Company could not find a market value for the stock. The Company did provide a December 31, 2001 audited financial statement for Impact Community Capital LLC which indicated a \$3,375,838 negative equity value for the Class B and Class C common shares as of December 31, 2000. The Impact Community Capital LLC common stock was not valued by the NAIC Securities Valuation Office as of December 31, 2000. **The entire \$51,387 for this common stock has been nonadmitted pursuant to RCW 48.12.180(1) that provides that common stocks shall be valued at their market value.**

11. SAFECO Surplus Lines Insurance Company

The Examiners made a \$127,437 adjustment reducing the December 31, 2000 book value of the Company's wholly-owned subsidiary, SAFECO Surplus Lines Insurance Company, from \$25,959,254 to \$25,831,817. The adjustment consisted of \$127,437 carried by SAFECO Surplus Lines Insurance Company in its 2000 Annual Statement under short-term investments for a money market investment that was not confirmed by the custodian and for which SAFECO Surplus Lines Insurance Company could not provide evidence of ownership.

RCW 48.12.180(3)(a) states, “The stock of a subsidiary of an insurer shall be valued on the basis of only such assets of such subsidiary as would constitute lawful investments for the insurer if acquired or held directly by the insurer”. This money market asset would not meet the criteria set forth in RCW 48.12.010 which provides that there shall only be allowed as assets for an insurer such assets as belong wholly and exclusively to the insurer. The Company is instructed to comply with RCW 48.12.180(3)(a) for the valuation of all subsidiaries.

12. Cash and Short-Term Investments

The Company had numerous general ledger balances that were unsupported by reconciliations. During the examination, the Company was able to reconcile many of these balances; however, as of the completion date of the examination field work there remained twelve general ledger balances that had not been reconciled. Of these non-reconciled general ledger accounts, there were accounts with negative balances totaling \$2,445,323 and accounts with positive balances totaling \$22,796. The negative balances have been accepted for purposes of this examination. The \$22,796 in positive balances have not been accepted and are nonadmitted for the purposes of this examination. The Company was not in compliance with RCW 48.05.280 which requires that the Company keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The Company was not in compliance with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs. **The Company is instructed to comply with RCW 48.05.280 which requires that the Company keep full and adequate accounts and records of its assets, obligations, transactions and affairs. The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.**

13. Other Invested Assets

As of December 31, 2000, the Company had an \$113,296 overstatement of an account balance for a private placement, Pequot Private Equity Fund III LP. The Company carried a statement value of \$1,539,750 when the actual value was \$1,426,454. The Company had not recognized a write-down in value that occurred during the period under examination. The overstatement has been reflected as nonadmitted for the purposes of this report.

The Company is instructed to properly track and report investment write downs to properly comply with RCW 48.05.280 which requires the Company to keep full and adequate records of its assets, obligations, transactions and affairs. Additionally, the Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

14. Receivable/Payable for Securities

The Company reported in its 2000 Annual Statement a \$758,058 receivable for securities and a \$593,200 payable for securities. The Company was unable to determine, from its PAM system records, the complete transactions representing the reported total amounts on the 2000 Annual Statement. The asset receivable for securities included transactions that were not received or collected within fifteen days from the settlement date. The NAIC Annual Statement Instructions provides that insurers exclude amounts receivable for securities that are not received within fifteen days of the end of the period. The receivable for securities was overstated by \$300,795 and the payable for securities was overstated by \$397,240 for a \$96,445 net overstatement of the payables. Additionally, certain transactions totaling \$198,281 were included in the reported outstanding receivable for securities that were not received or collected within ninety days from the settlement date. The receivable/payable for securities was determined to be \$101,836 overstated (\$198,281 less \$96,445) as of December 31, 2000 and is reflected as nonadmitted for the purposes of this report.

The Company is instructed to put in place controls to properly monitor and report accurately receivables/payables of securities to comply with RCW 48.05.250(1) which requires the Company to file a true statement of its financial condition, transactions and affairs and to comply with RCW 48.05.280 which provides that every insurer shall keep full and adequate accounts and records of its assets, obligations, transactions and affairs. Additionally, the Company is instructed to comply with WAC 284-07-050 which requires each authorized insurer to file an annual statement in the form and context as promulgated by the NAIC.

15. Agents' Balances or Uncollected Premiums

The Company, through the intercompany pooling agreement, had two receivables in connection with its direct participation in the Florida Windstorm Underwriting Association (the Association) and the Company's business with the Association as derived from the assumption of the American States' insurance business in 1997. The Association was prohibited by its state charter from distributing any excess amounts not needed by the Association. The Company's portion of the receivable from the Association was determined to have been \$2,095,938. This amount was to be written off by the Company at the end of 2000; however, the Company was unable to separate the lines of business written with the Association from the American States accounting system. The inclusion of these receivables as assets was not in compliance with RCW 48.12.010(10) which allows as assets only those recoverables from underwriting associations that were collectible. The Company, through the intercompany pooling agreement, failed to reconcile its accounts receivable for agents' balances in connection with transactions with various insurance and reinsurance syndicates and the treaties therewith. The Company's portion of the unreconciled amounts totaled \$148,133. The Company acknowledged that it was unable to provide the reconciliations and that such reconciliations will be preformed in the future. Due to the lack of such reconciliations, the Company was unable to determine if the amounts

receivable were in excess of ninety days past due. The inclusion of these receivables as assets was not in compliance with RCW 48.12.010(5) which allows as assets in the course of collection only those premiums that were not more than ninety days past due.

The Company, through the intercompany pooling agreement, had agents' balances that had been due for over ten years but had not been written off. The Company's portion of these agents' balances in excess of ninety days totaled \$44,033. The inclusion of these receivables as assets were not in compliance with RCW 48.12.010(5) which allowed as assets in the course of collection only those premiums that were not more than ninety days past due.

Testing of the 2000 year-end amounts for agents' balances or uncollected premiums was not possible due to the fact that the Company's records for such accounts for these assets were routinely overwritten on a monthly basis. This was not in compliance with RCW 48.05.280 which required that the Company keep full and adequate accounts and records of its assets, obligations, transactions, and affairs. Since the data for agents' balances was not available and could not be tested as of December 31, 2000, the examination team traced and tested agents' balances from a December 31, 2001 master file provided by the Company and selected records were sampled and traced back to year end 2000 data.

The above collective adjustments of Agents' balances totaling \$2,288,104 have been nonadmitted on the balance sheet of this report. The Company is instructed to comply with RCW 48.12.010(5) and (10) in the determination of the admissibility of agents' balances or uncollected premiums. The Company is instructed to comply with RCW 48.05.280 which requires that the Company keep full and adequate accounts and records of its assets, obligations, transactions and affairs, and to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

16. Accrued Interest on Investments

Our examination noted the following errors in the reporting of accrued interest and dividends:

- a) The underwriting and investment exhibit, Part 1, Page 6 of the Company's 2000 Annual Statement reported \$32,863,209 in accrued interest on bonds; however, Schedule D, Part 1 reported \$32,700,209 in accrued interest on bonds.
- b) The underwriting and investment exhibit, Part 1, Page 6 of the Company's 2000 Annual Statement reported \$287,037 in accrued interest on short-term investments; however, Schedule DA, Part 1 reported \$432,334 in accrued interest on short-term investments.
- c) The underwriting and investment exhibit, Part 1, Page 6 of the Company's 2000 Annual Statement reported \$800,331 in dividends declared and unpaid on common stocks; however, Schedule D, Part 2, Section 2 reported \$722,617 in dividends declared and unpaid on common stocks.

- d) The underwriting and investment exhibit, Part 1, Page 6 of the Company's 2000 Annual Statement reported \$38,359 in accrued interest on cash deposits; however, Schedule E, Part 1 reported \$33,057 in accrued interest on cash deposits.

The above four errors resulted in the underwriting and investment exhibit reporting \$100,719 more in accrued interest than what was reported in the four supporting schedules. The \$100,719 in unsupported accrued interest has been nonadmitted on the financial statements of this report and the Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

17. Prepaid Guaranty Fund Surcharges

The Company included as an admitted asset \$274,073 in prepayments to several state insurance guaranty funds that should have been expensed as they were not assessments by the insurance guaranty funds but surcharges for expenses. RCW 48.12.020(2) expressly does not allow as assets in any determination of the financial condition of an insurer any prepaid expenses. During the examination, the Company wrote-off these surcharges.

The Company is instructed to comply with RCW 48.12.020 which provides that prepaid expenses shall not be allowed as assets in the determination of the financial condition of an insurer and is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

18. Unsecured Advances to Agents

During 1997, the Company advanced \$30,000 each to twelve individual underwriters at SAFECO Lloyds Insurance Company, a Texas insurer on the Lloyds plan and an indirect affiliate of the Company. Each individual advance to the underwriters was for the purpose of funding the underwriter's contribution at that Lloyds plan. These advance payments have been nonadmitted pursuant to the provisions of RCW 48.12.020(3) as such unsecured advances to agents shall not be allowed as assets in any determination of the financial condition of an insurer. The Company included the \$360,000 total of these payments on its 2000 Annual Statement under the caption "Aggregate write-ins for other than invested assets: Other assets".

The Company is instructed to comply with RCW 48.12.020(3) which provides that unsecured advances to agents shall not be allowed as assets in the determination of the financial condition of an insurer. The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

19. SAFECO UK Limited Capacity Purchase

The Company included in its aggregate write-ins for other than invested assets \$2,009,455 as the total of payments made in 1998 and 1999 to an affiliated agent, R. F. Bailey (Underwriting Agencies) Limited to purchase additional capacity in another affiliate, SAFECO UK Limited.

RCW 48.12.020(3) expressly does not allow as assets in any determination of the financial condition of an insurer any unsecured advances to agents.

The Company is instructed to comply with RCW 48.12.020 which provides that unsecured advances to agents shall not be allowed as assets in the determination of the financial condition of an insurer. The Company is instructed to comply with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

20. Safekeeping of Securities

As of December 31, 2000, the Company had a September 22, 1995 custodial agreement with BankAmerica State Trust Company as authorized agent for Seattle-First National Bank. A September 22, 1995 letter from The Bank of New York indicated that a corporate custody agreement dated July 13, 1987 between SAFECO companies and BankAmerica Corporation was being assigned to BNY Western Trust Company. The 1995 letter was incorrect in that it should have referred to the 1995 agreement rather than the 1987 agreement. During the examination, the Company entered into a new custody agreement with BNY Western Trust Company dated July 23, 2001. The 2001 agreement was amended by the Company on August 23, 2001 in order to comply with the NAIC guidelines.

The Company is instructed to use due care and diligence in the tracking and oversight of custodial arrangements entered into in order to comply with 48.05.280 which requires the Company to keep full and adequate accounts and records of its affairs. The Company is also instructed to maintain compliance with NAIC guidelines.

21. Incomplete and Incorrect Finance Committee Minutes

- a) Quarterly minutes of the Company's Finance Committee covering the period from January 1, 1996 through December 31, 2000 were incomplete as the Company was unable to locate the August 5, 1996 minutes covering the investment transactions for the second quarter of 1996. Schedule D, Part 4 of the Company's 1999 Annual Statement reported the donation of 1,500 shares of the common stock of Washington Mutual, Inc. The shares donated by the Company to a charity were reported as a common stock sale in the August 2, 1999 minutes of the Company's Finance Committee meeting. The transaction advice for the sale of the investment (donation) had a place for two authorized signatures; however, the form was not signed. It was not known who in the Company makes the decisions as to what securities were donated and which charity received the donation. The reporting of the donation as a sale in the Finance Committee minutes was a violation of RCW 48.12.340.
- b) The minutes of the Company's Finance Committee reported the profits and losses on the transactions; however, there were instances where the profits and losses reported in the minutes did not agree with the gains and losses in Schedule D, Parts 3, 4 and 5. The Company indicated that the differences were the result of database errors and that the Company would research the errors so it would not happen in the future. The reporting of profits or losses in the Finance Committee minutes that were not the same as the profits or

losses reported in the Annual Statement was not in compliance with RCW 48.13.350 which requires a true record of earnings on investments.

- c) The October 30, 2000 Finance Committee minutes reflected the sale of a negative 143 shares of the common stock of AMS Services, Inc., on July 1, 2000 and that the Company received a negative \$140,584 for the shares having a negative book value of \$1,003,569 resulting in a gain of \$862,985. The Company responded to the Examination team that the database that pulls information from the Company's accounting system pulled the incorrect data into the minutes of the Finance Committee and instead of being a negative 143 shares, a negative \$140,584 being received and a negative \$1,003,569 cost, the number of shares and amounts should have been positive amounts resulting in a \$862,985 loss rather than a \$862,985 gain. The reporting of profits or losses in the Finance Committee minutes that were not the same as the profits or losses reported in the Annual Statement was not in compliance with RCW 48.13.350 which requires a true record of earnings on investments.
- d) During October 1998, the Company acquired 105 bonds from affiliate American States Insurance Company, 64 bonds from affiliate American Economy Insurance Company and 8 bonds from affiliate Insurance Company of Illinois. During October 1998, the Company transferred 34 common stocks to American States Insurance Company and 14 common stocks to American Economy Insurance Company. Securities that were involved in intercompany purchases or transfers were not recorded in the Company's Finance Committee minutes.
- e) On February 16, 1999, the Company and certain affiliated companies entered into a securities lending agreement with The Bank of New York. The Finance Committee minutes indicated that the 1999 agreement was ratified by the committee on April 30, 2001. The Company's failure to approve the agreement in 1999 was a violation of RCW 48.13.340.

The Company is instructed to comply with RCW 48.13.340 which provides that no investment, sale or exchange shall be made by any domestic company unless authorized or approved by its Board of Directors or by a committee charged by the Board of Directors or the Bylaws with the duty of making such investment, sale or exchange. The Company is instructed to comply with RCW 48.13.350 which provides a record of the earnings on investments and with RCW 48.05.280 which provides that every insurer shall keep full and adequate accounts and records of its assets, obligations, transactions and affairs.

22. Investment in Impact Promissory Notes

As of December 31, 2000, the Company owned a promissory note issued by Impact Community Capital LLC having an admitted value of \$1,728,672 and having accrued interest of \$11,861. The note was acquired by the Company on July 18, 2000. A December 31, 2001 audited financial statement of Impact Community Capital LLC indicated that this entity was organized on March 10, 1998 (the Company was unable to provide financial statements as of December 31, 2000). RCW 48.13.050(1) provided in part that a Washington domestic insurer may invest in corporate obligations which are secured by adequate collateral security and bear fixed interest during each of any three, including the last two, of the five fiscal years next preceding the date of

acquisition by the insurer. Impact Community Capital LLC was not a five year old corporation at the time that the Company acquired the promissory note on July 18, 2000. RCW 48.13.275 provided that notwithstanding the provisions of RCW 48.13.050, an insurer may invest its funds in obligations rated by the Securities Valuation Office. Documentation received directly from the NAIC indicated that the security had not been rated by the Securities Valuation Office as of December 31, 2000. For these reasons, the Examiners have not admitted the \$1,728,672 value of the Impact Community Capital LLC promissory note and the \$11,861 in accrued interest thereon as the Company was not in compliance with RCW 48.13.050(1). The Company was not in compliance with RCW 48.05.250(1) which requires that the Company file a true statement of its financial condition, transactions and affairs.

The Company is instructed to comply with RCW 48.13.050 which provides in part that a Washington domestic insurer may invest in corporate obligations which are secured by adequate collateral security and bear fixed interest during each of any three, including the last two, of the five fiscal years next preceding the date of acquisition by the insurer, and RCW 48.05.250 which requires that the Company file a true statement of its financial condition, transactions and affairs.

COMMENTS AND RECOMMENDATIONS

The examination developed the following comments and recommendations:

1. Investment Guidelines

The investment guidelines adopted by the Company on May 1, 2000 covered both the SAFECO Group of life companies and the SAFECO Group of property and casualty companies on a consolidated basis. Both the 2000 and 2001 investment guidelines had paragraphs that were incorrectly numbered or incomplete.

The Company adopted new investment guidelines effective January 1, 2002 that were correctly numbered; however, these guidelines were also on a consolidated basis for the life and property /casualty companies in the SAFECO Group. Before the January 1, 2002 investment guidelines were adopted, it was suggested to the Company that they be prepared on an individual company basis rather than on a consolidated basis. The consolidated guidelines adopted in 2002 currently cover the SAFECO Group of companies that are domiciled in a number of different states and have different limitations for various assets. An example of the investment limitations on an individual company basis are contained in RCW 48.13.180 and RCW 48.13.273.

It is recommended the Company adopt individual investment guidelines that cover the investment requirements in the Washington Insurance Code.

2. Securities Lending Agreement

- a) On February 16, 1999, the Company and certain affiliated companies entered into a securities lending agreement with The Bank of New York. As of December 31, 2000, the bank reported that there were 24 loaned securities consisting of 20 bonds having a par value of \$26,142,000, one preferred stock and three common stocks that were held in the Company's name. The securities loaned December 31, 2000 included several foreign securities for which the Company did not receive collateral of 105% at the time the loans were made as the Agreement required such level of collateral for foreign securities.

It is recommended that the Company adhere to the Agreement and require The Bank of New York to obtain the necessary collateral.

- b) On December 31, 2000, the names of three of the borrowing brokers pursuant to the Agreement furnished by The Bank of New York did not agree with the exact names of the brokers on the February 1999 list of approved brokers. The Company indicated that the brokers had changed their names or merged since Schedule 1 of the Agreement that listed the approved brokers had been prepared.

It is recommended that the Company loan securities only to the brokers listed in Schedule 1 of the 1999 Agreement or amend Schedule 1 as the names of approved brokers change or new brokers are added.

HISTORY

SAFECO Insurance Company of America was incorporated on September 2, 1953 under the laws of the state of Washington and began active operations on October 1, 1953. Operations were conducted under the corporate title Selective Auto and Fire Insurance Company of America until November 2, 1953 at which time the present name was adopted. Paid-up capital of \$5,000,000 consisted of 20,000 common shares at \$250 par value each.

CAPITAL AND SURPLUS

As of December 31, 2000, the authorized capital stock of the Company consisted of 20,000 shares of common stock with a par value of \$250 per share, of which 20,000 shares were issued and outstanding.

Dividends Paid to Shareholder

Dividends paid by the Company during the five-year period covered by this examination to SAFECO Corporation, the parent company, were as follows:

<u>Year</u>	<u>Dividends Paid To Shareholders</u>
1996	\$ 75,000,000
1997	383,000,000
1998	144,500,000
1999	168,000,000
2000	93,500,000

Dividends Paid to Policyholders

Dividends paid by the Company during the five-year period covered by this examination to policyholders were as follows:

<u>Year</u>	<u>Dividends Paid To Policyholders</u>
1996	\$ 8,597,095
1997	9,152,744
1998	4,702,792
1999	3,390,635
2000	3,119,893

MANAGEMENT AND CONTROL

Shareholder

The Company's outstanding shares were 100% owned by SAFECO Corporation (“the Corporation”) an insurance holding company incorporated under the laws of the state of Washington. The Corporation, directly or indirectly, owned the stock of operating subsidiaries engaged in various phases of the insurance business and other financially related lines of business. The home offices of the Corporation and the Company were located in Seattle, Washington.

Board of Directors

The affairs of the Company were managed and its corporate powers were exercised by the authority of a nine member Board of Directors. The membership of the Board as of December 31, 2000, together with the city and state of residence and principal business or professional affiliation of each director, were as follows:

<u>Name/Address</u>	<u>Position(s)/Principal Affiliation(s)</u>
Donald Shelton Chapman Woodinville, Washington	Senior Vice President, Chief Operating Officer SAFECO Insurance Company of America (Commercial Insurance)
Boh Andrew Dickey Woodinville, Washington	President and Chief Operating Officer SAFECO Corporation
Roger Harry Eigsti Seattle, Washington	Chairman and Chief Executive Officer SAFECO Corporation
Dale Ellis Lauer Woodinville, Washington	Senior Vice President SAFECO Insurance Company of America (American States Business Insurance)
William Thomas Lebo Lake Forest Park, Washington	Executive Vice President SAFECO Insurance Company of America
Rodney Allen Pierson Redmond, Washington	Senior Vice President, Chief Financial Officer, Secretary SAFECO Corporation
James Walter Ruddy Mercer Island, Washington	Senior Vice President, General Counsel SAFECO Corporation
Ronald Lee Spaulding Mill Creek, Washington	Treasurer and Chief Investment Officer SAFECO Corporation
Randall Howard Talbot Medina, Washington	President SAFECO Life Insurance Company

In January 2001, Roger Harry Eigsti, Chairman of the Board of Directors and Boh Andrew Dickey, Company President, resigned from the Board of Directors. Roger Floyd Harbin and Michael Sean McGavick were elected directors with Mr. McGavick appointed Chairman of the Board.

Officers

Officers of the Company as of December 31, 2000 were:

<u>Name</u>	<u>Position</u>
Boh Andrew Dickey	President
Steven Conrad Bauer	Treasurer
Rodney Allen Pierson	Secretary and Vice President
Richard Robert Berls	Vice President
Donald Shelton Chapman	Vice President
Peter Edward Dunn	Vice President
Dale Ellis Lauer	Vice President
William Thomas Lebo	Vice President
James Arthur Schmidt	Vice President
Robert Clark Taylor	Vice President
William Edward Thomas	Vice President

Effective January 30, 2001, Boh Andrew Dickey resigned as president of the Company and Michael Sean McGavick was appointed as president.

Finance Committee

The Company's Finance Committee consisted of the following members as of December 31, 2000:

Roger Harry Eigsti – Chairman
Boh Andrew Dickey
Rodney Allen Pierson
Ronald Lee Spaulding

During January 2001, Roger Harry Eigsti and Boh Andrew Dickey resigned from the Finance Committee and Michael Sean McGavick was appointed as a member of the Finance Committee. The number of members on the Finance Committee was reduced from four to three members.

CONFLICT OF INTEREST

The Company had an operating procedure for disclosing conflicts of interest to the Board of Directors. Statements are circulated among the directors, officers and key employees every year as set forth in the Company's Policy of Ethical Standards, Conflicts of Interest and Compliance with Laws. The Company had a procedure for obtaining disclosure statements from new appointees during the interim.

A review of the completed statements disclosed that the directors, officers and key employees had no conflicts of interest as of December 31, 2000.

AFFILIATED COMPANIES

The Company was a wholly-owned subsidiary of SAFECO Corporation, the ultimate controlling person. As a member of an Insurance Holding Company System, registration statements are required to be filed in accordance with RCW 48.31B.025 and WAC 284-18-300. SAFECO Corporation filed the registration statements for each year under examination on behalf of the Company, its parent company and its affiliated companies.

The following chart is taken from the SAFECO Corporation Organizational and Entity Chart:

SAFECO Corporation	100% Publicly Owned
SAFECO Financial Products, Inc.	100% SAFECO Corporation
SAFECO Insurance Company of Oregon	100% SAFECO Corporation
General America Corporation	100% SAFECO Corporation
Talbot Financial Corporation	100% General America Corporation
F. B. Beattie & Co., Inc.	100% General America Corporation
SAFECO Investment Services, Inc.	100% General America Corporation
SAFECO Select Insurance Services, Inc.	100% General America Corporation
R. F. Bailey Holding Limited	100% General America Corporation
General America Corporation of Texas – Attorney in Fact for:	100% General America Corporation
SAFECO Lloyds Insurance Company	Attorney in Fact
American States Lloyds Insurance Company	Attorney in Fact
First National Insurance Company of America	100% SAFECO Corporation
SAFECO Insurance Company of America	100% SAFECO Corporation
SAFECO Management Corporation	100% SAFECO Insurance Company of America
SAFECO Surplus Lines Insurance Company	100% SAFECO Insurance Company of America
Emerald City Insurance Agency, Inc.	100% SAFECO Insurance Company of America
SAFECO National Insurance Company (Missouri)	100% SAFECO Corporation
General Insurance Company of America	100% SAFECO Corporation
SAFECO Insurance Company of Pennsylvania	100% General Insurance Company of America
SAFECO Insurance Company of Illinois	100% SAFECO Corporation
Insurance Company of Illinois	100% SAFECO Insurance Company of Illinois
American States Insurance Company (Indiana)	100% SAFECO Corporation
American Economy Insurance Company (Indiana)	100% SAFECO Corporation
American States Insurance Company of Texas	100% American Economy Insurance Company
	100% SAFECO Corporation
American States Preferred Insurance Company (Indiana)	
SAFECO Credit Company Inc.	100% SAFECO Corporation
SAFECO Properties, Inc.	100% SAFECO Corporation
Winmar Company, Inc.	100% SAFECO Properties, Inc.
SAFECARE Company, Inc.	100% SAFECO Properties, Inc.
SAFECO National Life Insurance Company	100% SAFECO Life Insurance Company

AFFILIATED COMPANIES, Cont'd

American States Life Insurance Company	100% SAFECO Life Insurance Company
First SAFECO National Life Insurance Company of New York	100% SAFECO Life Insurance Company
D. W. Van Dyke & Co., Inc.	100% SAFECO Life Insurance Company
Medical Risk Managers, Inc.	15% SAFECO Life Insurance Company 85% D. W. Van Dyke & Co., Inc.
SAFECO Asset Management Company	100% SAFECO Corporation
Barrier Ridge LLC	100% SAFECO Corporation
SAFECO Services Corporation	100% SAFECO Corporation
SAFECO Securities, Inc.	100% SAFECO Corporation
SAFECO eCommerce, Inc.	100% SAFECO Corporation
SAFECO Trust Company	100% SAFECO Corporation
SAFECO UK Limited	100% SAFECO Corporation
SAFECO Administrative Services, Inc.	100% SAFECO Corporation
SAFECO Assigned Benefits Service Company	100% SAFECO Corporation

The Company, and SAFECO Corporation, both failed to include in their organizational charts numerous insurance agencies which were owned either directly by SAFECO Corporation or by an affiliate. The NAIC Annual Statement Instructions indicate for Schedule Y, Part 1, that a chart or listing presenting the identities of and interrelationships between the parent, all affiliated insurers and other affiliates should be attached to the Annual Statement. RCW 48.01.050 defined an insurer as every person engaged in the business of making contracts of insurance. The Company did not list the following insurance agencies in Schedule Y, Part 1 (shown below with the parent company relationship as taken from the organizational chart):

- SAFECO Insurance Company of America
 - Emerald City Insurance Agency, Inc.
 - Puget Structured Benefit Agency, Inc.
- SAFECO Select Insurance Services, Inc.
 - Pilot Insurance Services, Inc.
- Talbot Agency, Inc.
 - Talbot Financial Services, Inc.
 - Talbot Insurance Agency of Alabama, Inc.
 - Talbot Insurance Agency of Texas, Inc.
 - Talbot Agency of Texas, Inc.
- General America Corporation
 - F. B. Beattie & Company, Inc.
 - F. B. Beattie Insurance Services, Inc.
 - R. F. Bailey Holding Limited
 - R. F. Bailey (Underwriting Services) Limited
- SAFECO Life Insurance Company
 - D. W. Van Dyke & Co., Inc.
 - Medical Risk Managers, Inc.

CORPORATE RECORDS

Minutes

The minutes of the Shareholder, Board of Directors and Finance Committee meetings for the period covered under examination were reviewed. Investments were reviewed by the Finance Committee and the Finance Committee minutes were ratified by the Board of Directors; however, the minutes for an August 5, 1996 quarterly Finance Committee meetings were not located by the Company during the examination.

Contracts/Service Agreements

As of December 31, 2000, the Company was party to the following contracts:

1. Inter-Company tax allocation agreement dated August 1, 1990. A consolidated return was filed by SAFECO Corporation with the companies included in Schedule Y of the Annual Statement in which there was an 80% or more ownership, except for American States Life Insurance Company. The allocation was based upon separate return calculations with current credit for net losses as such losses offset taxable income of other members of the consolidated group. Intercompany tax balances were settled quarterly.
2. Expense Sharing Agreement dated November 3, 1983. The Agreement covers payroll, use of real property, and miscellaneous expenses for sixteen stock companies within the SAFECO Group, which includes the six Washington domestic insurance companies. All of the companies are 100%-owned direct or indirect subsidiaries of SAFECO Corporation, the ultimate controlling person in the SAFECO holding company system.
3. Lease between the Company and General America Corporation for real estate. As of December 31, 2000, the lease called for monthly payments by the Company of \$202,968 per month (\$2,435,616 per year) until 2005. The lease provided for annual escalation limit of 5% per year, based on the consumer price index.
4. A Short-Term Borrowing Agreement dated October 27, 1997 between the Company, as lender, and SAFECO Credit Company, Inc., as borrower.
5. The Company and twenty other affiliated companies in the SAFECO Group were named in an Intercompany Short-Term Borrowing Agreement effective November 15, 2000.
6. The Company had a service contract with SAFECO Lloyds Insurance Company, an affiliate, in which the Company agreed to render certain services for and on behalf of SAFECO Lloyds Insurance Company pertaining to routine insurance company operations.

7. The Company had agreed to guarantee the debt service payments of Market Square Real Estate, Inc., an affiliate, on \$10,136,987 of tax exempt bonds to be repaid in 2006.

Intercompany Agreements should be used to document recurring transaction patterns between or among the SAFECO Group member companies. RCW 48.31B.030(1)(a)(iv), requires that records are to "...clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees..." An extensive volume of investment transactions were conducted between the SAFECO insurance companies and SAFECO Asset Management Company, but there was no intercompany agreement specifying the parties' rights, duties and compensation. All such agreements are required to be filed and approved by OIC. See item 4 under the "INSTRUCTIONS" portion of this Examination Report.

FIDELITY BONDS AND OTHER INSURANCE

The Company's fidelity insurance was extended to affiliated companies through a Financial Institution Bond issued to SAFECO Corporation which provided coverage up to \$3,000,000 aggregate with no deductible. The companies carried excess insurance which provided an additional amount of coverage in layers through several carriers. The minimum amount of fidelity insurance coverage recommended by the NAIC for a company of this size was \$3,300,000 to \$3,500,000. This minimum amount was met with the Financial Institution Bond and the excess insurance.

The Company was a named insured on various insurance policies issued to its parent, SAFECO Corporation, that provided protection against certain property and liability losses. Policies providing property coverage for buildings and contents, comprehensive commercial general liability and automobile bodily injury and property damage coverage were in effect during the period covered by this examination.

The Company was a named insured on a Directors and Officers Liability Policy with an authorized insurance carrier. Errors and Omissions coverage was also provided under this policy.

OFFICERS', EMPLOYEES' AND AGENTS' WELFARE AND PENSION PLANS

The employees of the SAFECO Group of property/casualty and life companies were treated as employees of SAFECO Insurance Company of America. The salaries and benefits paid or accrued to these employees were allocated and prorated to the various companies in the Group based on the intercompany pooling agreement and other intercompany arrangements.

The SAFECO Group had the following benefit plans available to officers, employees and their dependents: Group Life Insurance, Accidental Death and Dismemberment, Long-Term Disability, and Medical and Dental. The Group contributed to the Life, Medical and Dental plans.

The SAFECO Group had the following retirement and profit sharing plans:

1. **Cash Balance Plan** – A defined contribution plan established in 1989. The plan provided an annual credit to each employee's account, regardless of profitability of the SAFECO Group. The amount was 3% of eligible compensation paid each year to the participants. The participant's balances were credited with interest at a rate of 5%.
2. **Profit Sharing Bonus** – A cash bonus was paid to the salaried employees who had completed one calendar year of service. Each year 10% of the "adjusted underwriting profit" of the SAFECO Group earned during the previous year was allocated to the profit sharing bonus plan. A cash bonus was then paid to the eligible employees based on percentage of the previous year's base salary. An employee with three or more calendar years of service could receive a maximum cash bonus of 10% of his or her previous year's salary.
3. **Profit Sharing Retirement Plan** – A defined contribution plan where contributions are based on the SAFECO Group's profit, 5% of net profit, before taxes and shareholder's dividends and after subtracting an amount credited to the Cash Balance Plan. The maximum contribution to the trust shall not exceed 12% of eligible compensation paid each year to the participants.
4. **Employees' Savings Plan** – A defined contribution plan was established during 1967. The plan was available to an employee after 12 calendar months of service. An employee could save up to 6% of basic salary. The companies contributed an amount equal to two-thirds of the employee's deduction.

SAFECO Corporation had a stock option plan for executives and key employees. The stock issued was in SAFECO Corporation. In addition, two non-qualified benefit plans were established during 1989 for the companies' contributions to the Profit Sharing Retirement Plan in excess of the amounts allowed by the Internal Revenue Service.

TERRITORY AND PLAN OF OPERATION

As of December 31, 2000, the Company was authorized to transact multiple lines business in all states of the United States; in the District of Columbia; and in the Dominion of Canada. The Company was licensed in Guam for surety business only. The Company was authorized by the United States Treasury Department to act as surety on bonds required by the Federal Government and was authorized by the United States Department of Labor to write workers' compensation under the Longshore and Harbor Workers' Compensation Act and its extensions.

The property and casualty insurance companies in the SAFECO Group were under common management. These insurance companies shared services in the areas of company operation, including investment, claim handling, state filings, legal, data processing, personnel, statistical and accounting.

The insurance companies within the SAFECO Group operate within the independent agency system. The SAFECO Group provided both personal and commercial property and casualty markets and was divided into two enterprise units for operational ease; SAFECO Business Insurance and SAFECO Personal Insurance. The business enterprise had five regional offices (Redmond, WA, Fountain Valley, CA, Richardson, TX, Indianapolis, IN, and Atlanta, GA) while the personal enterprise had two regional offices (Redmond, WA and Atlanta, GA). Appropriate claims offices were maintained throughout the United States to provide effective and efficient service to claimants.

GROWTH OF COMPANY

The growth of the Company for the past five years is reflected in the following exhibit (000's omitted) prepared from copies of the filed Annual Statements:

<u>Year</u>	<u>Assets</u>	<u>Liabilities</u>	<u>Capital</u>	<u>Surplus</u>	<u>Premiums Earned</u>
2000	\$2,999,450	\$2,293,130	\$5,000	\$701,320	\$1,501,970
1999	3,246,133	2,440,816	5,000	800,317	1,444,370
1998	3,121,014	2,216,786	5,000	899,228	1,388,746
1997	2,731,361	1,800,752	5,000	925,609	1,276,022
1996	2,742,928	1,675,299	5,000	1,062,629	1,205,943

LOSS EXPERIENCE

The reserves carried by the combined property and casualty companies of the SAFECO Group for these liabilities were \$3,482,472,780 and \$786,665,886, respectively, as of December 31, 2000.

The reserves for the combined companies were reviewed by the casualty actuarial staff employed by the OIC. Company personnel provided loss and loss adjustment expense development data for these lines of business as of June 30, 2002 (in other words, the data included eighteen months of development subsequent to the examination period). Based on the analysis of data through June 30, 2002, the OIC's actuarial staff concluded that the companies booked reserves, particularly for the workers' compensation and general liability lines of business, were deficient as of December 31, 2000. Since December 31, 2000, the companies have taken significant steps to strengthen their loss and loss adjustment expense reserves for 2000 and prior years. These steps were reflected, in part, in the one year loss development of \$339,274,000 for all lines of business shown on Page 23 of the combined companies' Annual Statement for 2001.

The OIC's actuarial staff made the following examination adjustments to the reserves as of December 31, 2000, on a combined-companies basis:

	<u>Booked Reserve</u>	<u>Examination Adjustment</u>	<u>Restated Reserve</u>
Losses	\$3,482,472,780	\$357,829,000	\$3,840,301,780
Loss adjustment expenses	786,665,886	93,742,000	880,407,886

Under the SAFECO intercompany pooling agreement, the Company's liability was 33% of the total. Therefore, the examination adjustments to the Company's reserves as of December 31, 2000 were:

	<u>Booked Reserve</u>	<u>Examination Adjustment</u>	<u>Restated Reserve</u>
Losses	\$1,149,216,017	\$118,083,570	\$1,267,299,587
Loss adjustment expenses	259,599,741	30,934,860	290,534,601

See "INSTRUCTIONS" No. 2, Loss and Loss Adjustment Expense Reserves where the Company is instructed to make provision for the examination adjustments to its loss and loss adjustment expense reserves which will place the Company in compliance with RCW 48.12.030(2). This section of the Washington Insurance Code provides that the Company estimate its provision to pay its unpaid losses and claims incurred on or prior to the date of the annual statement together with the expense of adjustment or settlement thereof.

REINSURANCE

Intercompany Pooling Agreement

The Company had entered into an intercompany reinsurance agreement whereby the Company assumed 100% of the direct business written by the affiliates listed below. The direct business written by SAFECO Insurance Company of America and the business assumed from the 14 affiliated companies was pooled. The Company arranged for excess and catastrophe reinsurance with nonaffiliated companies, as needed. The pooled business was retroceded to the following companies in the percentages stated below:

SAFECO Insurance Company of America	33%
General Insurance Company of America	23%
First National Insurance Company of America	2%
SAFECO National Insurance Company	2%
SAFECO Insurance Company of Illinois	5%
American States Insurance Company	19%
American States Preferred Insurance Company	2%

REINSURANCE, Cont'd

American Economy Insurance Company	14%
SAFECO Lloyds Insurance Company	0%
SAFECO Insurance Company of Pennsylvania	0%
SAFECO Insurance Company of Oregon	0%
SAFECO Surplus Lines Insurance Company	0%
Insurance Company of Illinois	0%
American States Insurance Company of Texas	0%
American States Lloyds Insurance Company	<u>0%</u>
Total	<u>100%</u>

Ceded Reinsurance

<u>Treaty Type</u>	<u>Line of Business</u>	<u>Coverage</u>
Catastrophe:		
Property	Enterprise's property business losses, including auto physical damage incurred within a 72 hour period from a weather related cause or 168 hours from an earthquake or freezing event	90% of \$50 mil xs \$100 mil 90% of \$50 mil xs \$150 mil 90% of \$100 mil xs \$200 mil 90% of \$200 mil xs \$300 mil
	Earthquake only – all states excluding California	90% of \$350 mil xs \$500 mil
Commercial Lines (Other than Select Markets):		
Automatic Facultative Property	Commercial property excluding Select Markets	From \$10 mil xs \$2 mil to \$130 mil xs \$20 mil per limit and class
Boiler and Machinery	Boiler machinery (mechanical breakdown)	100% of Boiler Machinery (Mechanical Breakdown)
Working Cover Treaty	Commercial property excluding Select Markets and workers' compensation including Select Markets	From \$1 mil xs \$1 mil to \$10 mil xs \$10 mil for property per class with \$9 mil xs \$3 mil for workers' compensation
Workers' Compensation Excess	Commercial insurance workers' compensation	100% of \$100 mil xs \$12 mil subject to a \$12 mil per claimant limitation

<u>Treaty Type</u>	<u>Line of Business</u>	<u>Coverage</u>
Umbrella	Commercial umbrella policies	100% of \$500,000 xs \$500,000 with 90% of \$4 mil xs \$1 mil and 100% of \$15 mil xs \$5 mil

Commercial Lines (Select Markets):

Select Markets Professional Liability Excess of Loss	Professional liability:	\$4,500,000 xs \$500,000 Coverage depends upon policy limit (if claim exceeds policy limits, retention is reapplied) as follows:
	Insurance agents errors and omissions	Maximum policy limit: \$5 mil
	Accountant's errors and omissions	Maximum policy limit: \$5 mil
	Lawyer's errors and Omissions	Maximum policy limit: \$5 mil
	H and W U/W Non-Profit errors and omissions	Maximum policy limit: \$5 mil
	Architect's and Engineer's errors and omissions	Maximum policy limit: \$5 mil
	Real estate agent's errors and omissions	Maximum policy limit: \$5 mil
	Independent adjuster's errors and omissions	Maximum policy limit:\$5 mil
Select Markets Quota Share	Select Markets Dentists errors and omissions	\$4 mil xs \$1 mil Maximum policy limit: \$5 mil
	Directors and officers for profit errors and omissions	70% of limits up to \$5 mil each policy, each loss
Employment Practices Liability	Employment practices liability	50% quota share policy limits \$1 mil

<u>Treaty Type</u>	<u>Line of Business</u>	<u>Coverage</u>
Specialty Lines	Specialty lines errors and omissions and directors and officers wrap	90% quota share
Property Excess of Loss	Identified as Individual Risk, SSIS, Minco, Black/White, North Island Social Services, Hampton Inns, and PHIS	\$4 mil xs \$1 mil with a \$5 mil xs \$5 mil layer for Individual Risk only
Select Markets Mini Catastrophe	Black/White, Hampton Inns, North Island Individual Risk Property, Minco, SSIS, and American Rental Property	95% of \$10 mil xs \$5 mil 95% of \$10 mil xs \$15 mil
Umbrella	Select Markets umbrella policies	70% of \$1 mil 95% of \$4 mil xs \$1 mil 100% of \$5 mil xs \$5 mil
Boiler and Machinery	Equipment breakdown – Dental Podiatrists	100% of Boiler Machinery (Mechanical Breakdown)
Libel and Slander	Media professional liability	90% of \$5 mil quota share
E-Commerce	Professional liability	90% of \$5 mil quota share
Personal Lines:		
High Value Homes	High value homeowner's property: A+B+C+D limits + SPP greater than \$2 mil	\$3 mil xs \$2 mil Maximum \$9 mil any one occurrence
Umbrella	Personal umbrella policies written on SAFECO paper	10% quota share first \$2 mil 100% of \$3 mil xs \$2 mil
Umbrella	Personal umbrella policies written on SAFECO paper where underlying limits are reinsured	100% of \$5 mil xs \$5 mil
Umbrella	Personal umbrella policies written on American States Insurance paper	50% of \$1 mil 100% of \$4 mil xs \$1 mil

<u>Treaty Type</u>	<u>Line of Business</u>	<u>Coverage</u>
Surety:		
Commercial Excess of Loss	Commercial surety bonds	\$15 mil xs \$5 mil net retention after SAFECO's quota share
Common Account Excess of Loss	Commercial and contract bonds bonds excluding financial products	\$15 mil xs \$60 mil
Quota Share	Commercial and contract bonds excluding financial products	50% quota share, maximum \$125 mil line of credit and \$60 mil bond maximum
Small Business Administration	Contract surety bonds on small businesses	70% of paid loss, not to exceed \$1,250,000 per bond
American States Business Insurance:		
Per Risk Property	Property including boiler and machinery	\$7,500,000 xs \$2,500,000 per risk, per occurrence. Maximum policy limit: \$22,500,000 any one occurrence
Workers' Compensation Excess Cover	Workers' compensation	\$9 mil xs \$3 mil any one occurrence. No MAOL.
Workers' Compensation Catastrophe Excess	Commercial lines workers' compensation business only	100% of \$100 mil xs \$12 mil Subject to \$12 mil per claimant limitation
Umbrella	Umbrella liability	100% of \$9 mil xs \$1 mil per policy, per claim
Employment Practices Liability	Employment practices liability	50% of first \$100,000 and 83% of the next \$900,000

<u>Treaty Type</u>	<u>Line of Business</u>	<u>Coverage</u>
State Programs In Force:		
Michigan Catastrophic Claims Association	Personal/Commercial personal injury protection	Unlimited personal injury protection xs \$250,000
Workers' Compensation Reinsurance Association of Minnesota	Commercial workers' compensation	Unlimited xs \$1,240,000
Illinois Mine Subsidence	Personal/Commercial	Equal to primary coverage or \$350,000 whichever is less.
Indiana Mine Subsidence	Personal/Commercial	From \$0 to \$100,000
Kentucky Mine Subsidence	Personal/Commercial	\$50,000 or less
Ohio Mine Subsidence	Personal/Commercial	\$50,000 or less with a 2% deductible
West Virginia Subsidence	Personal/Commercial	100% not to exceed \$75,000

FAIR Plans:

The Company participates in FAIR Plans and other involuntary pools and associations established by state law or state insurance regulations in the states in which the Company operates. These facilities are under the supervision of state regulatory authorities and provide outlets to policyholders that cannot secure coverage through normal insurance channels.

Syndicates and Pools:

The Company participates on a limited percentage basis in retrocessional pools for the following underwriting syndicates and pools:

American Hull Insurance Syndicate
American Nuclear Insurers (Liability and Property Pools)
Associated Aviation Underwriters
Excess & Casualty Reinsurance Association
General Reinsurance Retrocession Pool
National Workers' Compensation Reinsurance Pool

Reinsurance agreements were reviewed for compliance with Washington reinsurance statutes. The reinsurers were verified as being authorized to do business in Washington and were properly classified in Schedule F of the Company's 2000 Annual Statement. The authorized non-United States reinsurers and the unauthorized reinsurers maintain either statutory compliant letters of credit for the benefit of the Company or the Company withholds adequate amounts for the recoverables or maintains offsetting ceded reinsurance balances payable. The Company appeared to be adequately monitoring its reinsurance program including the financial condition of the reinsurers. The overall reinsurance program appeared to be adequate for the Company's exposure and ability to assume risk. The reinsurance treaties include a solvency clause in compliance with RCW 48.12.160(3).

The Company had no reinsurance commutations of significance during the period covered by this examination. The Company had no collectibility issues for reinsurance recoverables. The Company had not entered into any reinsurance intermediary-broker agreements in connection with the placement or reinsurance relating to the Company's insurance business.

ACCOUNTS AND RECORDS

The external audit firm of Ernst & Young LLP was retained by the Company to audit its statutory financial statements. Reports for 1999 and 2000 were provided as well as the work papers for 2000. As part of the audit work papers, the internal control structure noted deficiencies in the timely preparation of bank reconciliations and the clearance of items listed on the reconciliations.

The Internal Audit Department of the parent company, SAFECO Corporation, performed audits of the Company and provided recommendations to management on internal controls and operational procedures.

The Examiners independently tested internal controls and the following significant weaknesses were found:

1. Investments – As demonstrated by the volume of monetary adjustments proposed for these invested assets, the Company was not fully complying with RCW 48.05.280, which required maintenance of “full and adequate accounts and records of its assets, obligations, transactions and affairs.” It was recognized that some problems were due to the inadequacy of a software “crosscheck” package. However, such packages did not relieve the Company of its obligation to perform human oversight reviews of its financial statements before filing them.
2. General Ledger Control (GLC) Accounts – Reconciliations between the general ledger and subsidiary records for a number of accounts, including cash, were centrally maintained for most SAFECO companies by one department, GLC. GLC identified differences between the general and subsidiary accounts and referred the specific items (variances) to the originating SAFECO department for investigation and potential correction. During the five-year period under examination, there were numerous variances that were not cleared but were continuously outstanding. This resulted from a lack of consistent accounting discipline and control and appropriate management guidance to clear variances on a timely basis. In mid-2002, the SAFECO Group of companies began the implementation of a new, stronger control process to ensure account accuracy and to control timely reconciliation of accounts.
3. Cash – A number of instances were noted in which the cash administrative data base contained erroneous or incomplete information, including Company bank accounts which did not appear on the general ledger or in the data base. This condition resulted from the opening or amendment of bank accounts by parties other than those in the central bank administration department. Company employees should be made aware that only the bank administration department can open or change bank accounts.
4. Agents’ Balances – Documentation for the December 31, 2000 balances had been overwritten by the time the information was requested in mid-2001. This was not in compliance with RCW 48.05.280, which requires maintenance of “...full and adequate accounts and records of its assets, obligations, transactions and affairs.” Support for year-end balances should be retained at least until after the year has been examined.
5. Short-Term Investments – Included in this asset were intercompany loans. These loans were made under a written agreement and were termed “Notes Receivable” in the Annual Statements. The loans were not supported by individual notes. The terminology should be changed to accurately describe the respective loans and notes should be executed for each loan. Schedule DA, Part 1 of the Company’s Annual Statement reported \$75,510,000 of intercompany notes which were actually overnight investments to outside entities.

During the examination, there was extensive intercompany lending to an affiliate, SAFECO Credit Company. The loans were formalized by written notes, but the notes were often repaid long after their due dates. This was contrary to both normal business practices between borrowers and the Washington Insurer Holding Company Act.

The volume of intercompany borrowing and external short-term investing was extensive for the many related SAFECO companies and was handled by a small cash administration staff, without consistent external review. The situation was undesirable from the viewpoint of both the staff and the Company, since errors, oversights and omissions went undetected for long periods.

6. Other Invested Assets – The asset included a private placement investment in Pequot Private Equity Fund III LP as of December 31, 2000. This investment had been devalued by \$113,296 since inception, but was retained at its original value on the Company's books, apparently because the Company did not periodically request verification of the value of the private placement. Periodic verification or other procedures to ascertain accurate values should be implemented.
7. Electronic Data Processing Equipment (EDP) – This asset reported in the respective Annual Statements during the five-year examination period was inaccurate and inconsistent. In 1996 and 1997, the hardware and software were reported as admitted assets, whether admissible or not. In 1998 and 1999, only software programs were claimed as admitted assets, but included both inadmissible application software and admissible systems software. During 2000, no admissible EDP assets were claimed, even though some existed. Future Annual Statements should include as admitted assets only the admissible hardware and software.
8. Aggregate Write-Ins For Other Than Invested Assets – This asset included a \$42,786,965 current value note receivable from an affiliate, General America Corporation (GAC), for the December 1998 purchase of the Redmond Service and Region Buildings for \$38,100,000. The note had increased to \$45,380,000 as of December 31, 2001, when it was updated with a December 31, 2002 repayment date. GAC was a subsidiary of SAFECO Corporation and was used as a vehicle for conducting various real estate ownership functions for the ultimate parent company. GAC did not possess either significant liquid assets or earnings sources and would be unlikely to obtain the favorable terms such as exits on an arm's length basis. Accordingly, the loan was considered not to be in compliance with the Insurer Holding Company Act requirement for terms that are "...fair and reasonable...". This was especially true in view of its continued extension and expansion. Permissible intercompany loans should meet the applicable requirements and be repaid within a reasonable time.

9. **Employee Tax Liability Accounts** – The liabilities for both the employer’s and the employees’ federal withholding taxes were distorted from 1999 through mid-2000. The payments made for both the employer and the employees were debited against the employer’s liability account. At the same time, credits were accumulated in the employees’ liability account without any reductions for payments made. The employer’s liability account had accumulated a debit (receivable) balance of \$77.7 million by December 31, 2000 and continued as a significant debit through May, 2002. The employees’ federal tax accounts reached a credit of \$153 million on May 31, 2002. At the same time, the payroll tax cash account balance contained debit variances of approximately \$96 million that were not cleared. In mid-2002, the cash variance situation received general notice and an internal audit report of the Payroll Department highlighted the tax account problems. A subsequent investigation led to accounting and systems corrections, without any impact on the statement of income in the Annual Statement. The aforementioned general ledger distortions were obscured in the respective Annual Statements by reclassification entries. The reclassifications began in 1999 to “correct” the general ledger balances for statement presentation, without doing anything to actually identify and correct the underlying problems. This situation showed the need for high-level reviews of general ledger balances before making adjusting and reclassification entries.
10. **Drafts Outstanding** – This liability should have been disclosed on the appropriate balance sheet line of the 2000 Annual Statement. As of December 31, 2000 the Company had \$15,504,019 of such drafts outstanding which were netted against the Cash accounts. These drafts outstanding should have been disclosed as a liability in the Annual Statement and not as an offset against cash. The Company’s presentation understated assets and liabilities by like amounts and had no effect on surplus.
11. **Aggregate Write-Ins For Liabilities** – The liability was misstated at December 31, 2000, because a William Mercer Actuarial Report was disregarded in computing the required pension fund addition. Additionally, a \$5,000,000 over-accrual adjustment was overlooked during the same process. The two items were substantially offsetting and as such, the net effect was not material. In the future, the relevant factors should be considered before establishing any accrual for financial statement purposes.
12. **Intercompany Tax Settlements** – Tax Settlements were not always concluded on a timely basis. This was in contravention of sound commercial practices and of the “third party” relationships implicitly required by the Washington Insurer Holding Company Act.

During the examination, the Company engaged an external firm to guide and oversee resolving the many cash and other account reconciliations that had been in process for years and to put in place new procedures and controls.

Electronic Data Processing System

The management of the Company had sufficient knowledge of electronic data processing issues and provided direction and oversight through its Business Application Groups. Systems development, acquisition and maintenance controls were evaluated to gain assurance that programs and systems were designed, tested, approved and implemented using appropriate controls. The internal controls in place provided for the proper separation of duties.

Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed and the controls exercised to maintain data security. Adequate procedures and controls were in place for mainframe and network operations.

CONTINGENT LIABILITIES AND LEASES

1. The Company had purchased structured settlement annuities from the companies listed below, under which the claimants are payees but for which the Company was contingently liable:

<u>Life Insurance Company</u>	<u>Loss Reserve Eliminated by Annuities</u>
SAFECO Life Insurance Company	\$32,758,962
Allstate Insurance Company	149,900
First Colony Life Insurance Company	<u>791,487</u>
Total	<u>\$33,700,349</u>

2. The Company had agreed to guarantee the debt service payments to an affiliate, Market Square Real Estate, Inc., on \$10,136,987 in tax-exempt bonds to be repaid in 2006.
3. The Company was obligated under real estate and data processing equipment leases which expire at various dates through 2005. The minimum rental commitments for the leases in effect as of December 31, 2000 were as follows:

<u>Year Payable</u>	<u>Amount</u>
2001	\$30,749,328
2002	27,738,243
2003	25,793,442
2004	19,675,940
2005	17,521,063

4. The Company had a lease with an affiliate, General America Corporation, for real estate. As of December 31, 2000, the lease called for monthly payments by the Company of \$202,968 per month (\$2,439,616 per year) until 2005. The lease provided for an annual escalation limit of 5% per year, based on the consumer price index. Two affiliates of the Company, General Insurance Company of America and First National Insurance Company of America, have jointly and severally guaranteed payment of each and every installment of rent to General America Corporation. The Company was not in compliance with the NAIC Annual Statement instructions regarding the disclosure of the guarantees of the two affiliates. These instructions require the reporting of the total amount of guarantees for affiliates.

SUBSEQUENT EVENTS

1. On December 20, 2002, the OIC issued Order No. 96 granting approval of a special consent investment. The Order, effective December 31, 2000, gave the Company special consent to acquire and hold foreign securities in excess of the limitations contained in RCW 48.13.030 and RCW 48.13.180. The Order provided that the investments authorized by this Order may be credited to the Company's minimum capital or surplus or required reserves pursuant to RCW 48.13.250. The investments authorized by the Order shall be eligible for classification as admitted assets of the Company. The Order indicated that the Company desired to be in compliance with the OIC's interpretation of the Code, and so intends to divest itself of these foreign securities no later than November 15, 2004, unless before that time the investments attain the standard of eligibility.
2. On September 27, 2001, the Company's parent, SAFECO Corporation, contributed \$135,000,000 in cash and 100% of the shares of SAFECO Insurance Company of Oregon valued at \$6,166,543. The two contributions were incorrectly reported as Capital Contributions in Note No. 10, Page 14.4 of the Company's 2001 Annual Statement and the \$141,166,543 was incorrectly reported as a Surplus Adjustment – Transferred from Capital on Page 4 of the Company's 2001 Annual Statement. The \$141,166,543 in contributions represented Paid in Surplus.

Schedule D, Part 3 of the Company's 2001 Annual Statement did not report the acquisition of the shares of SAFECO Insurance Company of Oregon from SAFECO Corporation. Schedule D, Part 2, Section 2 of the 2001 Annual Statement reported the ownership of SAFECO Insurance Company of Oregon, but did not report the number of shares owned in Column 3 or the rate per share used to obtain the fair value in Column 6. Schedule D, Part 6, Section 1 of the Company's 2001 Annual Statement did not reflect the number of shares of SAFECO Insurance Company of Oregon owned in Column 8.

3. Schedule D, Part 4 of the Company's 2001 Annual Statement reported approximately \$5,000,000 in write-downs for bonds issued by Global Crossing, McLeod USA, Rural Metro Corporation and for shares of common stock in Sherwood International.
4. During the first quarter of 2002, the Company wrote down Global Crossing notes by \$156,250. During the second quarter of 2002, the Company wrote down MCI Communication notes by \$718,429 and WorldCom notes by \$514,291. During the third quarter of 2002, the Company wrote down Advanced Lighting notes by \$915,675 and Global Crossing notes by an additional \$62,500.
5. Subsequent to December 31, 2000, the Company disposed of the Impact Community Capital LLC notes having a December 31, 2000 admitted value of \$4,910,334. One of the issues owned December 31, 2000 and disposed of in 2001 was incorrectly reported in Schedule D, Part 3 of the Company's 2001 Annual Statement as a negative acquisition rather than as a disposal in Schedule D, Part 4 of the Company's 2001 Annual Statement.
6. During November 2001, the Company's Bylaws were amended to revise the Regular Meeting verbiage. The reference to a specific meeting date each quarter was removed and replaced with wording that requires a quarterly meeting on a date and place to be specified. This amendment was made to allow the Board of Directors more flexibility and places the Company's Bylaws in compliance with the other insurance companies within the SAFECO Group.
7. On December 20, 2002, SAFECO Corporation made a capital contribution of \$75,000,000 to the Company.
8. The NAIC adopted Statements of Statutory Accounting Principles (Codification) effective January 1, 2001. The effect of Codification resulted in a \$57,827,019 increase in the Company's 2001 Statutory Surplus.
9. The Company did not pay any dividends to its shareholder, SAFECO Corporation, during 2001. The Company paid \$75,500,000 in dividends to its shareholder, SAFECO Corporation, during 2002.
10. The reserves carried by the combined property and casualty companies of the SAFECO Group for the loss reserves and for the loss adjustment expenses were \$3,482,472,780 and \$786,665,886, respectively, as of December 31, 2000. During the third quarter of 2001, the SAFECO Group completed a review of its loss reserve adequacy. As a result of this review, the SAFECO Group increased reserves by \$240,000,000 which relates to recent developments in prior year claims as follows: \$80,000,000 for workers' compensation, \$90,000,000 for construction defect, and \$70,000,000 for other coverages including asbestos and environmental. The review of loss reserve adequacy concluded that personal lines reserves were adequate. The increase in reserves for these particular lines was included in the end of the year loss development for all lines which totaled \$339,274,000 as shown on Page 23 of the combined companies' Annual Statement for 2001.

In the case of workers' compensation, the \$80,000,000 increase was due to unexpected development of prior year claims and continued increases in medical costs. This includes the impact of administrative rulings that have been more favorable to plaintiffs' claims for compensation, particularly in the states of California and Florida. The estimation of liabilities related to construction defects and asbestos and environmental claims noted continued emergence of adverse loss experience for construction defect and asbestos and environmental claims due to newly emerging trends in the disposition of such cases. As a result of the review, the SAFECO Group concluded that ultimate losses for these lines will be higher in the range of possible outcomes than previously estimated.

The \$90,000,000 increase in construction defect reserves was due to continued adverse development on prior year claims and the expansion of the number of claims in states outside California. Recent state courts' rulings have expanded the number of claims beyond those contemplated by the SAFECO Group's original estimate.

The \$70,000,000 increase in reserves for other lines, including asbestos and environmental claims, relates to the anticipated increase in asbestos claims relating primarily to the discontinued reinsurance operations acquired in the American States purchase.

During the first quarter of 2002, SAFECO Group also added \$10,000,000 to loss reserves for workers' compensation policies from prior years.

Under the SAFECO intercompany pooling agreement, the Company's liability was 33% of the total.

FINANCIAL STATEMENTS

The following statements reflect the financial condition of the Company as of December 31, 2000, as determined by this examination:

Balance Sheet
As of December 31, 2000

Statement of Income
Year Ended December 31, 2000

Capital and Surplus Account
As of December 31, 2000

Reconciliation of Capital and Surplus Account
For the Five Year Examination Period (Per Company)

Comparative Analysis of Changes in Surplus
As of December 31, 2000

SAFECO INSURANCE COMPANY OF AMERICA
Balance Sheet
As of December 31, 2000

	BALANCE PER COMPANY*	NOTES	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION
<u>ASSETS</u>				
Bonds	\$ 1,752,910,087	1 to 3	\$ (47,970,614)	\$ 1,704,939,473
Stocks:				
Preferred stocks	9,825,200	4		9,825,200
Common stocks	642,239,034	5 to 8	(1,258,465)	640,980,569
Mortgage loans on real estate:				-
First liens	42,786,965	9	(14,211,965)	28,575,000
Real estate:				-
Properties occupied by the company	33,351,632			33,351,632
Other properties	273,383			273,383
Cash and short-term investments	100,307,793	10	(22,796)	100,284,997
Other invested assets	1,539,750	11	(113,296)	1,426,454
Receivable for securities	785,058	12	(101,836)	683,222
Subtotals, cash and invested assets	\$ 2,584,018,902		\$ (63,678,972)	\$ 2,520,339,930
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	52,683,451	13	(2,288,104)	50,395,347
Premiums, agents' balances and installments booked but deferred and not yet due	250,728,272			250,728,272
Accrued retrospective premiums	1,505,777			1,505,777
Reinsurance recoverables on loss and loss adjustment expense payments	12,943,541			12,943,541
Federal income tax recoverable and interest thereon	12,103,965			12,103,965
Interest, dividends and real estate income due and accrued	34,192,576	1, 3, 14	(851,252)	33,341,324
Receivable from parent, subsidiaries and affiliates	48,630,203			48,630,203
Aggregate write-ins for other than invested assets:				
Other assets	2,643,528	15	(2,643,528)	-
Total Assets	<u>\$ 2,999,450,215</u>		<u>\$ (69,461,856)</u>	<u>\$ 2,929,988,359</u>

*Balance Per Company after reclassification of \$42,786,965 from "Aggregate write-ins for other than invested assets: Other assets" to "Mortgage loans on real estate: First liens"

SAFECO INSURANCE COMPANY OF AMERICA
Balance Sheet
As of December 31, 2000

	<u>BALANCE</u> <u>PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION</u> <u>ADJUSTMENTS</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>
<u>LIABILITIES</u>				
Losses	\$ 1,149,216,017	16	\$ 118,083,570	\$ 1,267,299,587
Loss adjustment expenses	259,599,741	17	30,934,860	290,534,601
Contingent commissions and other similar charges	30,221,958			30,221,958
Other expenses (excluding taxes, licenses and fees)	39,437,930			39,437,930
Unearned premiums	584,301,869			584,301,869
Dividends declared and unpaid:				
Policyholders	8,388,015			8,388,015
Funds held by company under reinsurance treaties	405,241			405,241
Amounts withheld or retained by company for account of others	27,639,906			27,639,906
Provision for reinsurance	10,235,293			10,235,293
Net adjustments in assets and liabilities due to foreign exchange rates	4,723,486			4,723,486
Payable to parent, subsidiaries and affiliates	98,244,172	18	2,012,384	100,256,556
Payable for securities	593,200			593,200
Aggregate write-ins for liabilities	<u>80,122,921</u>		<u>-</u>	<u>80,122,921</u>
Total Liabilities	<u>\$ 2,293,129,749</u>		<u>\$ 151,030,814</u>	<u>\$ 2,444,160,563</u>
<u>SURPLUS AND OTHER FUNDS</u>				
Common capital stock	\$ 5,000,000		\$ -	\$ 5,000,000
Gross paid in and contributed surplus	11,139,941			11,139,941
Unassigned funds (surplus)	<u>690,180,525</u>		<u>(220,492,670)</u>	<u>469,687,855</u>
Surplus as regards policyholders	<u>\$ 706,320,466</u>		<u>\$ (220,492,670)</u>	<u>\$ 485,827,796</u>
Total Liabilities, Surplus and Other Funds	<u>\$ 2,999,450,215</u>		<u>\$ (69,461,856)</u>	<u>\$ 2,929,988,359</u>

SAFECO INSURANCE COMPANY OF AMERICA
Statement of Income
For the Year-Ended December 31, 2000

	<u>BALANCE PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION ADJUSTMENTS</u>	<u>BALANCE PER EXAMINATION</u>
<u>UNDERWRITING INCOME</u>				
Premiums earned	\$ 1,501,970,494		\$ -	\$ 1,501,970,494
DEDUCTIONS:				
Losses incurred	\$ 1,061,035,323	16	\$ 118,083,570	\$ 1,179,118,893
Loss expenses incurred	183,050,873	17	30,934,860	213,985,733
Other underwriting expenses incurred	434,632,940		-	434,632,940
Total underwriting deductions	<u>\$ 1,678,719,136</u>		<u>\$ 149,018,430</u>	<u>\$ 1,827,737,566</u>
Net underwriting gain or (loss)	<u>\$ (176,748,642)</u>		<u>\$ (149,018,430)</u>	<u>\$ (325,767,072)</u>
<u>INVESTMENT INCOME</u>				
Net investment income earned	\$ 141,174,038		\$ -	\$ 141,174,038
Net realized capital gains or (losses)	51,551,168		-	51,551,168
Net investment gain or (loss)	<u>\$ 192,725,206</u>		<u>\$ -</u>	<u>\$ 192,725,206</u>
<u>OTHER INCOME</u>				
Net gain or (loss) from agents' or premium balances charged off	\$ (1,021,972)		\$ -	\$ (1,021,972)
Finance and service charges not included in premiums	6,183,886		-	6,183,886
Total other income	<u>\$ 5,161,914</u>		<u>\$ -</u>	<u>\$ 5,161,914</u>
Net income before dividends to policyholders and before federal and foreign income taxes	\$ 21,138,478		\$ (149,018,430)	\$ (127,879,952)
Dividends to policyholders	3,119,893		-	3,119,893
Net income, after dividends to policyholders but before federal and foreign income taxes	\$ 18,018,585		\$ (149,018,430)	\$ (130,999,845)
Federal and foreign income taxes incurred	<u>(18,696,244)</u>		<u>-</u>	<u>(18,696,244)</u>
Net Income	<u>\$ 36,714,829</u>		<u>\$ (149,018,430)</u>	<u>\$ (112,303,601)</u>

SAFECO INSURANCE COMPANY OF AMERICA
Capital and Surplus Account
As of December 31, 2000

	<u>BALANCE</u> <u>PER COMPANY</u>	<u>NOTES</u>	<u>EXAMINATION</u> <u>ADJUSTMENTS</u>	<u>BALANCE PER</u> <u>EXAMINATION</u>
Surplus as Regards Policyholders, December 31 Prior Year	<u>\$ 805,316,936</u>		<u>\$ -</u>	<u>\$ 805,316,936</u>
<u>GAINS AND (LOSSES) IN SURPLUS</u>				
Net income	\$ 36,714,829	16 & 17	\$ (149,018,430)	\$ (112,303,601)
Net unrealized capital gains or (losses)	1,962,366	1 to 15	(69,461,856)	(67,499,490)
Change in non-admitted assets	(36,758,402)		-	(36,758,402)
Change in provision for reinsurance	(6,675,562)			(6,675,562)
Change in foreign exchange adjustment	(739,701)			(739,701)
Change in payable to parent, subsidiaries and affiliates		18	(2,012,384)	(2,012,384)
Dividends to stockholders (cash)	<u>(93,500,000)</u>		<u>-</u>	<u>(93,500,000)</u>
Change in surplus as regards policyholders for the year	<u>\$ (98,996,470)</u>		<u>\$ (220,492,670)</u>	<u>\$ (319,489,140)</u>
Surplus as Regards Policyholders, December 31 Current Year	<u>\$ 706,320,466</u>		<u>\$ (220,492,670)</u>	<u>\$ 485,827,796</u>

SAFECO INSURANCE COMPANY OF AMERICA
Reconciliation of Capital and Surplus Account
For the Five Year Examination Period
(Per Company)*

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>	<u>1996</u>
Capital and Surplus as Regards					
Policyholders, December 31 Prior Year	\$ 805,316,936	\$ 904,228,557	\$ 930,608,668	\$ 1,067,628,384	\$ 922,363,745
GAINS AND (LOSSES) IN SURPLUS					
Net Income	\$ 36,714,829	\$ 93,583,084	\$ 168,314,982	\$ 168,468,557	\$ 166,247,073
Net unrealized capital gains or (losses)	1,962,366	12,441,307	19,610,691	118,426,120	65,858,373
Change in non-admitted assets	(36,758,402)	(32,864,014)	(59,417,394)	(37,186,175)	(10,189,097)
Change in provision for reinsurance	(6,675,562)	1,542,653	423,960	1,001,789	178,897
Change in foreign exchange adjustment	(739,701)	(5,614,651)	(6,082,621)	(2,656,338)	(2,671,275)
Change in excess of statutory reserves over statement reserves			2,073,671	(2,073,669)	840,668
Dividends to stockholders (cash)	(93,500,000)	(168,000,000)	(144,500,000)	(383,000,000)	(75,000,000)
Extraordinary amounts of taxes for prior years			(16,136,138)		
Aggregate write-ins for gains and losses in surplus	-	-	9,332,738 *	-	-
Change in surplus as regards policyholders for the year	<u>\$ (98,996,470)</u>	<u>\$ (98,911,621)</u>	<u>\$ (26,380,111)</u>	<u>\$ (137,019,716)</u>	<u>\$ 145,264,639</u>
Capital and Surplus as Regards					
Policyholders, December 31 Current Year	\$ 706,320,466	\$ 805,316,936	\$ 904,228,557	\$ 930,608,668	\$ 1,067,628,384

* Acquisition charge for American States Insurance Company

SAFECO INSURANCE COMPANY OF AMERICA
Comparative Analysis of Changes in Surplus
As of December 31, 2000

The following is a reconciliation of surplus as regards policyholders between that reported by the Company and as determined by the examination:

	<u>PER</u> <u>COMPANY*</u>	<u>PER</u> <u>EXAMINATION</u>	<u>INCREASE</u> <u>(DECREASE)</u> <u>IN SURPLUS</u>	<u>TOTALS</u>
Capital and Surplus, December 31, 2000 - Per Annual Statement				\$ 706,320,466
<u>ASSETS</u>				
Bonds	\$ 1,752,910,087	\$ 1,704,939,473	\$ (47,970,614)	
Stocks:				
Common stocks	642,239,034	640,980,569	(1,258,465)	
Mortgage loans on real estate:				
First Liens	42,786,965	28,575,000	(14,211,965)	
Cash and short-term investments	100,307,793	100,284,997	(22,796)	
Other invested assets	1,539,750	1,426,454	(113,296)	
Receivable for securities	785,058	683,222	(101,836)	
Premiums and agents' balances in course of collection	52,683,451	50,395,347	(2,288,104)	
Interest, dividends and real estate income due and accrued	34,192,576	33,341,324	(851,252)	
Aggregate write-ins for other than invested assets	2,643,528	-	(2,643,528)	
<u>LIABILITIES</u>				
Losses	1,149,216,017	1,267,299,587	(118,083,570)	
Loss adjustment expenses	259,599,741	290,534,601	(30,934,860)	
Payable to parent, subsidiaries and affiliates	98,244,172	100,256,556	(2,012,384)	
Change in surplus				(220,492,670)
Capital and Surplus, December 31, Per Examination				\$ <u>485,827,796</u>

*Balance Per Company after reclassification of \$42,786,965 from "Aggregate write-ins for other than invested assets: Other assets" to "Mortgage loans on real estate: First liens"

NOTES TO FINANCIAL STATEMENTS

1. Bonds - As of December 31, 2000, the Company had United States Government Bonds having an admitted value of \$46,241,942 pledged to Citibank under an agreement effective November 25, 1998. The pledged assets had \$738,672 in accrued interest as of December 31, 2000. The bonds were pledged in connection with SAFECO UK Limited and were not in compliance with RCW 48.12.010. The \$46,241,942 statement value of the bonds and the \$738,672 in accrued interest has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 9, Bonds Pledged for Letter of Credit.
2. Bonds - As of December 31, 2000, the Company had invested in foreign bonds having an admitted value of \$20,884,353 and \$203,963 in accrued interest. RCW 48.13.180 prohibited the Company's investment in foreign bonds. The remedies under the Code did not provide for the nonadmission of the foreign securities. See "INSTRUCTIONS" No. 3, Prohibited Investments in Foreign Securities.
3. Bonds - The Company acquired a promissory note issued by Impact Community Capital LLC on July 18, 2000. The note had an admitted value of \$1,728,672 as of December 31, 2000. The note had \$11,861 in accrued interest as of December 31, 2000. A December 31, 2001 audited financial statement for Impact Community Capital LLC indicated that it was organized on March 10, 1998. The Company was not in compliance with RCW 48.13.050(1) which provides that the Company may invest in corporate obligations bearing fixed interest during each of any three, including the last two, of the five fiscal years preceding the date of acquisition. RCW 48.13.050 provides that an insurer may invest its funds in obligations rated by the Securities Valuation Office. Documentation received directly from the NAIC indicated the security had not been rated by the Securities Valuation Office as of December 31, 2000. The \$1,728,672 statement value of the notes and the \$11,861 in accrued interest has been nonadmitted on the financial statement of this report. See "INSTRUCTIONS" No. 22, Investment in Impact Promissory Notes.
4. Stocks: Preferred - As of December 31, 2000, the Company owned a foreign preferred stock having a statement value of \$9,825,200. The Company reported \$203,640 in dividends declared and unpaid on the foreign preferred stock. RCW 48.13.180 prohibited the Company's investment in foreign preferred stocks. The remedies under the Code did not provide for the nonadmission of the foreign security. See "INSTRUCTIONS" No. 3, Prohibited Investments in Foreign Securities.

5. Stocks: Common – As of December 31, 2000, the Company owned a foreign common stock (Sherwood International PPC) having a statement value of \$938,154 that was overvalued by the Company. The stock had a market value of \$111,160 as of December 31, 2000 resulting in an overvaluation of \$826,994. The Company was not in compliance with RCW 48.12.180(1) which required that common stocks shall be valued at their market value. The \$826,994 overvaluation has been nonadmitted on the financial statement of this report. RCW 48.13.180 prohibited the Company's investment in foreign securities; however, the remedies under the Code did not provide for the nonadmission of the \$111,160 market value of the foreign security. See "INSTRUCTIONS" No. 3. Prohibited Investments in Foreign Securities and see "INSTRUCTIONS" No. 10a), Stock Valuations.
6. Stocks: Common – As of December 31, 2000, the Company reported that it owned 36 shares of AMS Services, Inc., common stock. It was determined during the examination that the Company owned only 18 of the AMS shares and that SAFECO Corporation owned the other 18 shares. The Company was unable to provide a December 31, 2000 market value or audited financial statement to support the \$252,647 admitted value of the shares. The Company was not in compliance with RCW 48.12.180(1) which required that common stocks shall be valued at their market value. The \$252,647 statement value has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 10b), Stock Valuations.
7. Stocks: Common – As of December 31, 2000, the Company reported that it owned one share of Impact Community Capital Class B common stock with a statement value of \$51,387. The financial statement provided by the Company during the examination indicated a negative equity value for the Class B Shares as of December 31, 2000 and the shares were not valued by the Securities Valuation Office of the NAIC. RCW 48.12.180(1) requires that common stocks shall be valued at their market value. The \$51,387 statement value has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 10c), Stock Valuations.
8. Stocks: Common - A \$127,437 adjustment was made by the examiners in the December 31, 2000 statement value of the Company's wholly-owned subsidiary, SAFECO Surplus Lines Insurance Company. The adjustment reduced the admitted value of the subsidiary from \$25,959,254 to \$25,831,817. The adjustment consisted of a \$127,437 short-term investment in a money market investment that the examiners were unable to confirm. RCW 48.12.010 provides that there shall only be allowed as assets for an insurer only such assets as belong wholly and exclusively to the insurer. The \$127,437 statement value of the investment reported on the financial statements of the wholly owned subsidiary has been nonadmitted on the balance sheet of this report. See "INSTRUCTIONS" No. 11, SAFECO Surplus Lines Insurance Company.

9. Mortgage Loans on Real Estate: First Liens - During December 1998, the Company loaned \$38,100,000 to an affiliate, General America Corporation, for the purpose of purchasing real estate. General America Corporation gave a promissory note and a deed of trust to the Company (the note was not in the name of the Company but issued to SAFECO Insurance Corporation, an unknown entity). A title policy was issued to the Company. As of December 31, 2000, the Company indicated that it had an account receivable of \$42,786,965 (the \$38,100,000 plus \$4,686,965 of interest through December 19, 2000) for this Promissory Note.

The issuance of an evidence of debt, the Promissory Note, secured by a recorded deed of trust, placed this asset under the provisions of RCW 48.13.110(1)(a), which allows the Company to invest in such evidences of debt along with other mortgages, mortgage bonds, notes and contracts. The \$42,786,965 asset has been reclassified from "Aggregate write-ins for other than invested assets: Other assets" to "Mortgage loans on real estate: First liens" on the financial statements of this report. The first lien mortgage loan was determined to be in \$14,211,965 in excess of the limitations found in RCW 48.13.120(1) and this amount has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 7, Promissory Note from Affiliate.

10. Cash and Short-Term Investments – As of December 31, 2000, the Company had numerous general ledger balances that were unsupported by reconciliations. During the examination, the Company was able to reconcile many of these balances; however, as of the completion date of the examination field work there remained twelve general ledger balances that had not been reconciled. The non-reconciled general ledger accounts included accounts with \$2,445,323 in negative balances and accounts with \$22,796 in positive balances. The negative balances have been accepted for purposes of this examination. The \$22,796 in positive balances was not accepted and has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 12, Cash and Short Term-Investments.
11. Other Invested Assets - As of December 31, 2000, the Company had overstated the account balance for a private placement, Pequot Private Equity Fund III LP. The Company carried a statement value of \$1,539,750 when the actual value was \$1,426,454. The \$113,296 overstatement has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 13, Other Invested Assets.

12. Receivable for Securities - The Company reported in its 2000 Annual Statement a \$1,539,750 receivable for securities and a \$593,200 payable for securities. The receivable for securities was overstated by \$300,795 and the payable for securities was overstated by \$397,240 for a \$96,445 net overstatement of the payables. Additionally, certain transactions totaling \$198,281 were included in the reported outstanding receivable for securities that were not received or collected within ninety days from the settlement date. The receivable/payable for securities was determined to be \$101,836 overstated (\$198,281 less \$96,445) as of December 31, 2000, and this amount has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 14, Receivable/Payable for Securities.
13. Agents' Balances or Uncollected Premiums: Premiums and Agents' Balances in Course of Collection – As of December 31, 2000, the Company participated in an intercompany pooling agreement. The Company's portion of the premiums and agents' balances in course of collection included \$2,095,938 in receivables from the Florida Windstorm Underwriting Association that were uncollectible, \$148,133 in unreconciled agents' balances in connection with transactions with insurance and reinsurance syndicates and treaties therewith, and \$44,033 in agents' balances that have been due for over ten years. Agents' balances totaling \$2,288,104 have been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 15, Agents' Balances or Uncollected Premiums.
14. Interest, Dividends and Real Estate Income Due and Accrued - The underwriting and investment exhibit, Part 1, Page 6 of the Company's 2000 Annual Statement reported accrued interest amounts for bonds, short-term investments, and cash deposits and reported declared and unpaid dividends on common stocks that were not supported by Schedules D, DA, and E of the 2000 Annual Statement. The accrued investment income reported in the three schedules was \$100,719 less than the admitted amount reported on the underwriting and investment exhibit. The \$100,719 has been nonadmitted on the financial statements of this report. See "INSTRUCTIONS" No. 16, Accrued Interest on Investments.
15. Aggregate Write-Ins for Other Than Invested Assets: Other Assets – The Company's 2000 Annual Statement reported an admitted amount of \$45,430,493 as of December 31, 2000. The examiners reclassified \$42,786,965 of the \$45,430,493 to "Mortgage Loans on Real Estate: First Liens" leaving a remaining balance of \$2,643,528. The \$2,643,528 consisted of the following assets that have been nonadmitted on the financial statements of this report:
 - a) The Company included as an admitted asset \$274,073 in prepayments to several state insurance guaranty funds that should have been expensed as they were surcharges for expenses. RCW 48.12.020(2) does not allow as assets any prepaid expenses. See "INSTRUCTIONS No. 17, Prepaid Guaranty Fund Surcharges.
 - b) During 1997, the Company advanced \$360,000 to 12 individual underwriters at SAFECO Lloyds Insurance Company. Each of the \$30,000 advances was for the purpose of funding the underwriters' contribution to the Lloyds plan. The \$360,000

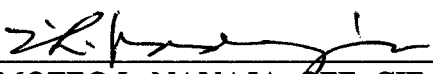
in unsecured advances to agents has been nonadmitted on the financial statements of this report pursuant to the provisions of RCW 48.12.020(3) which does not allow as an asset of an insurer any unsecured advances to agents. See "INSTRUCTIONS" No. 18, Unsecured Advances to Agents.

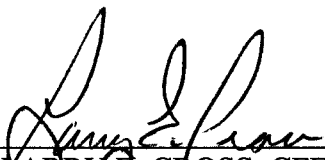
- c) The Company included \$2,009,455 as the total of payments made during 1998 and 1999 to an affiliated agent, R. F. Bailey (Underwriting Agencies) Limited to purchase additional capacity in SAFECO UK Limited. RCW 48.12.020(3) which does not allow as an asset of an insurer any unsecured advances to agents. See "INSTRUCTIONS" No. 19, SAFECO UK Limited Capacity Purchase.
- 16. Losses - The reserves for losses reported by the SAFECO Group of companies on a combined basis as of December 31, 2000 were increased \$357,829,000. The Company's 33% portion of the increase in reserves under the intercompany pooling agreement resulted in an examination adjustment of \$118,083,570 for losses. See "INSTRUCTIONS" No. 2, Loss and Loss Adjustment Expense Reserves.
 - 17. Loss Adjustment Expenses - The reserves for loss adjustment expenses reported by the SAFECO Group of companies on a combined basis as of December 31, 2000 were increased \$93,742,000. The Company's 33% portion of the increase in reserves under the intercompany pooling agreement resulted in an examination adjustment of \$30,934,860 for loss adjustment expenses. See "INSTRUCTIONS" No. 2, Loss and Loss Adjustment Expense Reserves.
 - 18. Payable to Parent, Subsidiary and Affiliates – As of December 31, 2000, the Company reported the ownership of AMS Services, Inc., common stock. During the examination it was determined that SAFECO Corporation and the Company each owned one-half of the AMS Services, Inc., common stock and that both entities should have shared in one-half of the \$4,024,768 in net dividends received by the Company and one-half of the expense reimbursements paid by the Company during 1999 and 2000. A \$2,012,384 liability has been established on the financial statements of this report for amounts that were due SAFECO Corporation as of December 31, 2000. See "INSTRUCTIONS" No. 10b, Stock Valuations.

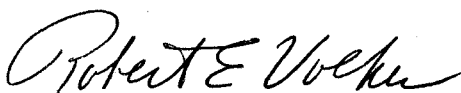
ACKNOWLEDGMENT

Examiners John J. Gaynard, CPA, CPCU, AFE, Peter M. Mendoza, CFE, CIE, Orlando R. Gabriel, Kehinde Ovbiebo, Constantine Arustamian, CPA, Mike Bosley, CPA, Charles J. Mitchell, CPA, Mitch Coe, CPA, Michael V. Jordan, CFE, CPA, MHP, Eric Slavich, Actuarial Analyst 2, and D. Lee Barclay, FCAS, MAAA, Senior Actuary, from the Washington State Office of Insurance Commissioner and Richard A. Randour, CFE, CPA, from the State of Delaware participated in the examination and preparation of this report.

Respectfully submitted,


TIMOTEO L. NAVAJA, CFE, CIE
Examiner-in-Charge
Office of Insurance Commissioner
State of Washington


LARRY E. CROSS, CFE, CIE
Representing State of Delaware
and NAIC Northeastern Zone



ROBERT E. VOLKER, CFE, CIE
Representing State of Nevada
and NAIC Western Zone

AFFIDAVIT

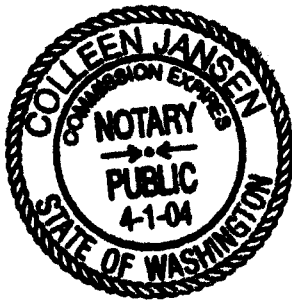
STATE OF WASHINGTON)
) ss
COUNTY OF KING)


Timoteo L. Navaja, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

He attests that the examination of SAFECO Insurance Company of America was performed in a manner consistent with the standards and procedures required or prescribed by the Washington State Office of Insurance Commissioner and the National Association of Insurance Commissioners (NAIC).


TIMOTEO L. NAVAJA, CFE, CIE
Examiner-in-Charge

Subscribed and sworn to before me on this 11th day of September, 2003.





Notary Public in and for the
State of Washington,
residing at Seattle.
My commission expires 4/1/04